

Cooper Panel Preliminary Report on SMSFs

30 April 2010

As part of its review of the Australian superannuation system, on 29 April the Cooper Panel released a preliminary report of its views on issues raised in its issues paper entitled “Phase 3: Structure” so far as they relate to SMSFs.

The report, entitled “Self-managed Super Solutions”, can be viewed on the [Super System Review website](#).

The Panel enunciated some guiding principles that it believes should underpin the regulation of SMSFs along with a vision for the SMSF sector. We will not outline those in this summary, instead preferring to go straight to the substantive policy views of the Panel on specific issues.

Note that the final report of the Cooper Panel is not due to be finalised until 30 June and the Government is yet to respond to the recommendations made in this preliminary report. Accordingly this update does not examine the merits or otherwise of the proposals in any great depth.

Barriers to establishing an SMSF

In what can be viewed as a positive for the SMSF sector the Panel has resisted recommending the more potent barriers to establishing and running an SMSF which were proposed in various submissions (typically from other sectors of the superannuation industry) including:

- mandatory trustee education;
- compulsory use of a custodian to hold fund assets;
- a minimum fund asset size; and
- licensing or registration of administration service providers.

The Panel is however exploring options aimed at ensuring that people for whom SMSFs are inappropriate cannot set them up.

Online module for prospective SMSF clients: At this stage its preferred option is to require a prospective SMSF member to complete an online module on a government website which would take them through their possible suitability to participate as a member and trustee of an SMSF on a self-assessment basis. Issues dealt with could include asset size to be cost competitive, compliance obligations, experience necessary, recognition of possible costs, time commitment and so on. The existing ATO declaration could also be rolled into this process so that the new SMSF member would go through an educative, and then a declarative, process.



Other options being explored by the Panel include:

- requiring one-off advice from a licensed financial adviser in order to establish an SMSF (either where the fund assets will be less than \$500,000 or in all cases) which would cover the issue of cost-ineffectiveness of funds below a certain size, investment restrictions and trustee obligations generally; and
- requiring those in the business of providing establishment services in relation to SMSFs to at least hold an 'SMSF establishment AFSL' (ie a licence that would only authorise that activity). So far as accountants are concerned, this recommendation is made in the context of the Government's Future of Financial Advice proposal to remove the accountants' exemption from licensing requirements in relation to advice on SMSF establishment announced on 26 April by Minister Bowen. However, not everyone would be required to use such a licensee or to get financial advice.

Also note the proposal to change the registration process upon establishment of an SMSF, to guard against fraud and illegal use of SMSFs, discussed later.

ATO regulatory power

The Panel believes that the ATO remains the appropriate regulator for SMSFs.

The Panel considers that the existing penalty regime provides the ATO with such severe weaponry (e.g. making a fund non-complying for tax purposes) that the ATO's ability to achieve optimal regulation is limited. While it doesn't recommend removal of the existing penalties, it does recommend that:

- the ATO be given the power to issue administrative penalties against SMSF trustees on a sliding scale reflective of the seriousness of the breach – these would be levied against the trustees or trustee directors, not paid from the fund;
- the Superannuation Industry (Supervision) Act 1993 ('SIS') be amended to provide the ATO with the power to issue relevant persons with a direction to rectify contraventions within a reasonable time (with a breach of a direction being a strict liability offence).

While the Panel does not favour mandating trustee education across the whole sector, it does believe that the ATO should be empowered to enforce compulsory education (again, at the trustee or directors' own expense) where non compliance with SIS, especially of a lower-level nature, is detected.

The Panel also recommends that the SIS covenant requiring fund assets to be kept separate from personal or employer assets should also be a SIS operating standard so that it can be enforced as such.

Super Complaints Tribunal jurisdiction on death benefits, insurance

Generally, the Panel does not favour extending external dispute resolution mechanisms to SMSFs. However, it does recommend that the jurisdiction of the SCT be extended



to resolve death benefit disputes between an SMSF and a beneficiary who is not a member or a person in their capacity as the legal personal representative of a deceased member, and to resolve disputed insurance claims (e.g. disability claims).

It does not recommend extending the jurisdiction to disputes between trustees, and it is unclear how the boundaries of the SCT's jurisdiction would be defined precisely.

The Panel also recommends that the additional resourcing required for the SCT be addressed by way of an (unspecified) increase to the SMSF supervisory levy.

Clarifying SIS

A rewrite. The Panel recommends that the SIS Act be restructured to separate and set out clearly those areas that are common for all funds and those areas that are only relevant to the individual superannuation sectors under the choice architecture model.

This proposal is essentially directed at changing the structure of the relevant rules to improve understanding, not the substance of the rules. The Panel's view is that this could ease the compliance burden and costs for SMSF trustees. Those familiar with attempts to rewrite income tax legislation (including the recent rewrite of superannuation fund tax rules as part of the Better Super reform) will recognise this sort of project would inevitably produce uncertainties and issues about the substance of the rules.

Binding rulings. Coupled with the rewrite, the Panel recommends that the ATO be given the power to issue binding rulings in relation to SMSFs.

SMSF service providers

Competency standards. The Panel considers that competency standards for SMSF advisers need to be raised. The Panel believes ASIC should amend RG 146 to include a specialist 'SMSF' knowledge requirement that must be obtained before advisers can provide advice in relation to SMSFs. It considers that this could be developed by ASIC, in consultation with industry and the 'expert advisory panel' proposed as part of the Future of Financial Advice reform package announced by Minister Bowen on 26 April 2010.

Adviser remuneration. The Panel's recommendations here are largely consistent with the Government's Future of Financial Advice reform package, although the Panel is currently minded to recommend that commission-based fees on all risk insurance be prohibited in all superannuation sectors, including SMSFs (whereas the Government has indicated that it will not move on risk insurance in the first phase of its reform).

Annual audits. Given the growing size of the SMSF sector and the importance of the audit role, the Panel believes that the current frequency of annual audits is appropriate and should not be reduced.



Approved SMSF auditors. The Panel favours an approved auditor framework where all auditors operate on a level playing field and enforcement is consistently applied. It believes compulsory registration, which is attached to ongoing competency requirements, would have a favourable impact on the professional standards across the whole industry. The Panel believes that the registration body should have the powers to set competency standards, develop and apply a robust penalty regime and have powers to disqualify and deregister auditors. The Panel believes that the powers and standards of the 'registration body' need to be developed in conjunction with industry; though the Panel favours the ASIC company auditor registration model, regardless of who is ultimately selected as the registrar.

Auditor independence. The Panel recommends legislating full audit independence whereby an individual or firm providing any service in connection with an SMSF or its individual trustees or trustee directors in any capacity is to be expressly prohibited from auditing that SMSF.

The Panel notes that the ATO's 2009 compliance activities targeting high risk approved auditors identified that:

- 29% of auditors were an SMSF's accountant and had prepared a material part of its financial statements; and
- 28% of auditors exhibited evidence of a relationship or conflict of interest that might impact the auditor's ability to be independent and had no safeguards to mitigate that risk.

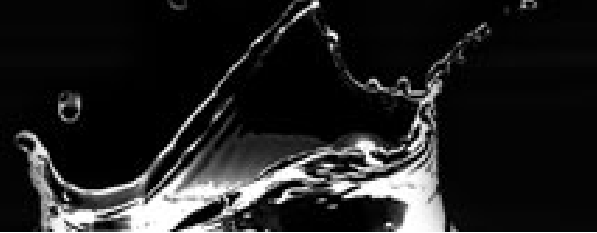
Investment restrictions

Gearing. In principle, the Panel has concerns with the concept of direct borrowing within superannuation funds and prefers the SIS borrowing rules as they existed before the 2007 relaxation, but has stopped short of recommending new constraints on borrowing.

Instead, the Panel recommends that the settings be reviewed in two years' time to ensure that borrowing has not become, and does not look like becoming, a significant focus of superannuation funds. (To assist in monitoring the levels of instalment warrant borrowings by superannuation funds, the Panel also recommends that credit providers should be required to collect and provide relevant data to APRA that would enable the RBA to publish statistics on the level of finance being provided to superannuation funds.)

In the meantime, the Government has indicated that it will fine tune borrowing-related settings (such as the proposed treatment of certain instalment arrangements as financial products) and presumably there will be an opportunity for the industry to satisfy the Government that the fine-tuned rules are sufficient.

In house assets. The Panel recommends in relation to the SMSF sector only that the 5 per cent in house asset limit be removed so that no in house assets would be allowed. SMSFs with existing in house asset investments be provided a transitional period, up to



30 June 2020, in which to dispose of them (and no new or further in house investments be permitted the during period). The Panel is not proposing to unwind the existing 1999 grandfathering arrangements or alter the existing in house asset definition exemptions.

Business real property etc.: As noted above, the Panel is not proposing to change existing in house asset exemptions such as the lease of business real property to related parties. The Panel acknowledges the longstanding nature of the business real property exemption, the benefits it provides to business and farmers (especially as it engages them with providing for their retirement) and the lack of reports of any significant abuse in this area.

Related party acquisitions and disposals: However, the Panel believes the current provisions relating to related party acquisitions and disposals are insufficient to mitigate the potential risk of transaction date and asset value manipulation to illegally benefit the SMSF or the related party (depending on the transaction). Accordingly the Panel recommends that the SIS rules on acquisitions and disposals between related parties should be amended in relation to SMSFs only, so that either:

- where an underlying market exists (for example, securities quoted for trading on ASX), all acquisitions and disposal of assets between SMSFs and related parties must be conducted through that market; or
- where an underlying market does not exist, acquisitions or disposals of assets between related parties must be supported by a current independent valuation from a registered valuer.

This would not typically apply to in specie contributions or rollovers to large superannuation funds.

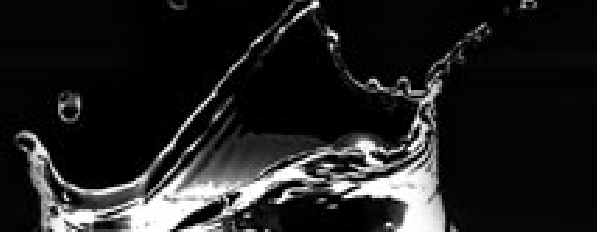
Collectables and personal use assets: The Panel recommends that:

- the acquisition of collectables and personal use assets by SMSF trustees be prohibited;
- SMSFs that own collectables or personal use assets be provided a transitional period, up to 30 June 2020, in which to dispose of those assets; and
- APRA-regulated funds be exempted from these changes.

Examples of the assets being referred to include:

- paintings;
- jewellery;
- antiques;
- stamp collections;
- wine, exotic cars;
- golf club memberships;
- race horses; and
- boats.

As the Panel notes, this measure will only affect a modest number of funds. However, from a policy perspective it could be perceived as “the thin end of the wedge” in terms of Government prescription of the range of investments a superannuation fund trustee can invest in, although the specific rationale here appears to be around misuse of the



assets. If that is the rationale, an alternative approach may have been to reinforce the application of existing sole purpose and related party rules.

Fund reporting

SMSF data collection: To improve the level of available information, additional statistical data would need to be collected from SMSFs. This will be addressed further in the Panel's final report which is due to be delivered to the Government in June 2010.

Net market valuations: The Panel considers that all SMSFs should be required to value assets annually at net market value, and that the ATO, in consultation with industry, publish valuation guidelines to ensure consistent and standardised valuation practices. However, the Panel does not believe that SMSFs should be required to prepare general purpose financial reports.

Reporting to members: To prompt those members with less involvement in the day-to-day running of the fund to be more aware of what is happening, the Panel believes there is some key information that SMSF trustees should provide annually to all SMSF members, beyond what the Corporations Act currently requires. This includes:

- whether or not a binding death benefit nomination is in place and if so, the name of the beneficiary(ies) and the date on which the nomination will lapse (if applicable);
- notification as to whether a pension is in place and whether that pension automatically reverts to the pensioner's spouse on death;
- whether the member's death benefit includes any insurance and if so, the amount of that insurance;
- showing the member's balance divided between each 'superannuation interest' held for that member in the fund;
- the investment return (after fees and tax) achieved on each member's balance over the previous financial year; and
- where investment choice is exercised, how the member balances have been invested.

Meeting minutes: The Panel considers minute-keeping in relation to many activities could be removed to reflect the existence and effect of records commonly maintained by SMSFs (e.g. bank statements, CHESS statements, contract notes and the like). The Panel would like to see the administration of an SMSF align more with the rules applying to small and single member proprietary companies under the Corporations Act, where meetings, minutes and other formalities have been reduced to an absolute minimum. Accordingly the Panel recommends (after appropriate industry consultation) that legislation be amended to remove SMSF trustee administrative burdens that are identified as unnecessary.

Online SMSF resource centre

The Panel believes SMSF trustees should have access to a central government website providing resources (such as general advice, statistics and educational material) that



would help them build their knowledge and competency voluntarily. This would require all SMSF information to be brought together, catalogued and indexed, and incorporate an enhanced 'search tool' enabling information to be accessed and found easily. The resource centre could provide further information on matters such as investments, compliance and regulatory changes and a register of SMSF service providers.

Fund establishment checks

The Panel believes that a single 'point of truth' needs to be established so that APRA-regulated funds can quickly and efficiently establish whether or not an SMSF that is the subject of a rollover request is legitimate.

The Panel recommends that:

- proof of identity checks be required for all people joining an SMSF, whether they are establishing a new fund or joining an existing fund;
- identification measures should not apply retrospectively except for existing SMSFs wishing to organise rollovers from an APRA-regulated fund;
- the SMSF registration process capture the details of the person who has provided advice in relation to the establishment of the SMSF (where applicable). This information should also be available to ASIC to assist in regulating AFSL holders and form part of the risk assessment process for both ASIC and the ATO;
- controls be put in place to ensure SMSFs can be neither established with, nor subsequently change their name to, the name of, or a name similar to, an existing APRA-regulated entity and that other naming rules applicable to bodies corporate under the Corporations Act be applied to SMSFs;
- Super Fund Lookup (or an alternative system) provide appropriate SMSF information to APRA-regulated funds (which would include member level details, confirmation that identification of member/trustees has occurred and the SMSFs bank account number) to enable the APRA-regulated fund to verify the details of SMSF membership before processing rollover requests to SMSFs;
- upon appropriate confirmation the APRA-regulated fund would immediately process the request and electronically transfer the rollover to the validated SMSF bank account;
- legislation be enacted to provide for criminal and civil sanctions to enable the ATO to penalise and discourage illegal early release scheme promoters;
- existing tax laws be amended so that: a) amounts illegally early released be taxed at the superannuation non-complying tax rate; and b) an additional penalty, based on a sliding scale of penalties that takes into account the individual circumstances, should apply; and
- rollovers to an SMSF be captured as a designated service under the AML/CTF Act.

SMSF trust deeds

The Panel recommends that the SIS Act be amended to reduce the need for amendments to SMSF trust deeds when the SIS legislation or tax laws change.



Insurance strategy for fund

The Panel recommends that the consideration of death and disability insurance for members should be incorporated as part of the investment strategy operating standard.

Fund size & trusteeship – no changes proposed

Maximum of 4 members: While the Panel accepts the arbitrary nature of the limit and sees some of the attractions for wider family participation, in response to a number of submissions the Panel notes that it does not propose to recommend changing the existing membership limit. It believes that the complications inherent in expanding the limit outweigh the possible advantages.

Corporate versus individual trustees: The Panel is attracted to the potential benefits provided by the corporate trustee structure but does not propose to recommend compulsory corporate trusteeship. It recognises that this is better addressed as an advice competency matter.

Conclusion

The recommendations made in the Panel's preliminary report on SMSFs are not yet Government policy. The implementation of the recommendations is subject to the acceptance of the Government and successful passage of legislation through Parliament.

We will keep you informed of further developments in this regard.

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