ASIC

Australian Securities & Investments Commission

Self-managed superannuation funds and complex products - ASIC update

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SMSF Professionals' Association of Australia (SPAA) Conference

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CHECK AGAINST DELIVERY

Introduction

My co-regulators have shared the work they are doing that impacts on self-managed superannuation funds (SMSFs), and ASIC likewise has been busy in this area.

Our role with respect to SMSFs is primarily geared towards regulating the gatekeepers, in particular financial advisers, SMSF auditors, issuers and distributors of financial products in which SMSFs invest, and to a lesser degree the SMSF trustees themselves.

Gatekeepers play a critical role in Australia's financial system, especially in the superannuation sector. We have an excellent system, which relies on investors making informed investment decisions and being prepared to accept the risks involved – but investors' confidence and ability to make informed investment decisions depends critically on gatekeepers in the system doing their job.

In September 2012, we established an SMSF taskforce in response to an increase in geared investment strategies, increasingly aggressive advertising, the collapse of Trio, and the subsequent Parliamentary Joint Committee on Corporations and Financial Services inquiry.

Deputy Chairman Peter Kell and I are jointly responsible for heading up the SMSF taskforce. We are also seeing an increase in investment in complex products, which I will specifically address shortly.

Improving the quality of advice given to SMSF investors

In April 2013, ASIC released Report 337 *SMSFs: Improving the quality of advice given to investors* (REP 337). The report summarises our findings from the first major project undertaken by the SMSF taskforce.

As part of this project, we conducted a review of over 100 investor files on the establishment of SMSFs – provided by financial planners and accountants. The files that were targeted were considered to be in high risk categories because they had lower balances or less diversified investments.

While most of the advice provided was considered adequate, there were pockets of poor advice. ASIC found issues in the following areas:

- advice was not sufficiently tailored to the needs of the investor
- replacement product disclosure was absent or inadequate

- insurance recommendations were absent or inadequate
- an inappropriate single asset class was provided to investors
- suitable alternatives to an SMSF were not considered, and
- there was inadequate consideration of investors' long-term retirement planning objectives.

Also of concern was the rise in aggressive advertisement of property purchases through SMSFs.

REP 337 contains practical guidance and examples that advisers can use to improve the quality of their SMSF advice, including:

- ensuring investors are aware of the serious and wide-ranging responsibilities and obligations that they must meet on an ongoing basis, and the potential consequences of failing to do so
- considering the suitability of the SMSF structure for that particular investor, having regard to:
  - the investor's fund balance
  - the costs and time associated with setting up and running an SMSF
  - the financial literacy skills required to run an SMSF, and
  - any particular investor characteristics that may make an SMSF structure inappropriate,
- discussing the risks associated with setting up an SMSF, including not having access to statutory compensation in cases of theft or fraud and reduced access to dispute resolution bodies
- ensuring the investment strategy and the restrictions that apply to SMSF investments are clear to the investor
- providing a balanced comparison of the advantages and disadvantages of an Australian Prudential Regulation Authority (APRA) regulated superannuation arrangement compared to an SMSF, including full disclosure of costs and any negatives that attach to SMSFs, and
- offering alternatives to SMSFs.

The Australian Taxation Office (ATO) regulates SMSFs and provides a number of useful resources to assist SMSF investors on their website.

Consultation on the quality of SMSF advice

As part of the SMSF taskforce's second major project, in September 2013, ASIC released a consultation paper on proposed guidance to improve the

quality of advice given to investors.[1] The consultation paper sought feedback on:

- proposals to require specific disclosures of information to investors, and
- the appropriate resource level investors should have before establishing an SMSF.

The proposals reflect the need to inform clients of the:

- duties and obligations associated with running an SMSF, including that trustees remain responsible for managing the fund even if they outsource some or all of their responsibilities
- risks associated with running an SMSF
- need to develop and implement an appropriate investment strategy for an SMSF
- time commitment and skills needed to run an SMSF effectively
- costs associated with setting up, running and winding up an SMSF
- need to consider and develop an exit strategy for an SMSF, and
- possibility that the laws and policies that affect SMSFs may change.

The proposals should be considered in conjunction with the practical guidance in REP 337.

ASIC commissioned Rice Warner to examine the minimum cost-effective balance for SMSFs when compared with APRA-regulated superannuation funds. CP 216 includes Rice Warner's report *Costs of Operating SMSFs*. ASIC sought feedback on Rice Warner's findings and the costs associated with setting up, running and winding up an SMSF.

Feedback to consultation

As part of our consultation, we held two separate roundtable discussions in October 2013 – one for industry and one for consumer representatives. Overall, stakeholders supported the disclosure proposals in CP 216. What was great to hear was that a number of industry associations indicated that their members had already been discussing the issues covered by the proposals. This is encouraging in terms of consumer protection and it indicates to ASIC that these proposals could be implemented with minimal cost and disruption.

Some stakeholders observed that advisers cannot satisfy their best interests' obligations unless they take into account the risks identified in the proposals. We agree with this and our final guidance will reflect this.

[1] Consultation Paper 216 *Advice on self-managed superannuation funds: Specific disclosure requirements and SMSF costs sought* (CP 216).

The feedback to Rice Warner's report on SMSF costs fell into two categories. Some were comfortable with the findings and indicated that their members approached cost and minimum balance issues consistent with Rice Warner's findings, while others believe that the report vastly overstated costs.

In general, industry stakeholders were more concerned with what they perceived as ASIC's intention to prescribe a mandatory minimum balance. We are not, however, proposing a mandated minimum balance – we are looking to provide clearer guidance on this issue based on research and industry and investor views. From a risk perspective, we are more likely to look at advice to set up a SMSF where the balance is outside a specific range. However, the balance is just one consideration and there are circumstances where advice for a small balance superannuation holder to set up an SMSF may still be in the best interests of the client – for example, where the investor has a concrete plan to transfer a large business asset into the fund within a specific time frame.

A number of consumer associations suggested requiring clear, detailed disclosure of set up, ongoing and exit costs, and a comparison of these costs with the cost of remaining in an APRA-regulated fund. We think this is a good idea and we are exploring it further. This work is likely to be completed in the coming months.

Unlicensed financial services businesses

ASIC is aware that there has been a sharp rise in promoters recommending investors either set up or use an existing SMSF to invest in property. These promoters may not be complying with the law.

Section 911A of the *Corporations Act 2001* (Corporations Act) requires any person carrying on a financial services business in Australia to hold an AFS licence or be a representative of an AFS licensee.

A person provides a financial service if they provide financial product advice. Under s766B of the Corporations Act, financial product advice is defined as a recommendation, a statement of opinion or a report of either of those things that is, or could reasonably be regarded as being, intended to influence a person's decision in relation to a financial product.

Providing financial product advice includes making a recommendation or a statement of opinion to a person to set up an SMSF or use an existing SMSF to purchase property through that SMSF. This is because the vehicle through which the underlying investment is made is an SMSF and an interest in an SMSF is a financial product. That is, a person who makes such a recommendation or statement of opinion provides financial product advice

even where the underlying investment – property in this case – is not a financial product.

ASIC is concerned that, with the increased popularity of SMSFs and property investment, real estate agents and property advisers may not realise that they may be carrying on a business of providing financial product advice and may need an AFS licence, or authorisation under an AFS licence, when making recommendations or statements of opinion to a person to use an SMSF to invest in property.

If a person does not hold an AFS licence or is not authorised by an AFS licensee, they can only provide factual information to consumers in relation to SMSFs. We have published Regulatory Guide 244 *Giving information, general advice and scaled advice* (RG 244) which explains the difference between factual information and financial product advice.

SMSF auditor registration

As part of the Stronger Super reforms, ASIC became the registration body for approved SMSF auditors from 31 January 2013. The reforms recognise the key gatekeeper role that approved SMSF auditors play. The objective of SMSF auditor registration is to raise the standard of SMSF auditor competency and ensure there are minimum standards across the sector.

It is important to emphasise here that the minimum standards are the very least that must be met. It is in the interest of every SMSF adviser, auditor and client to continually seek to improve their skills and competency.

In January 2013, we released Regulatory Guide 243 *Registration of self-managed superannuation fund auditors* (RG 243) to provide further guidance to the industry on registration requirements.

Since the introduction of the SMSF auditor registration regime on 31 January 2013, we has received 7,882 applications and registered and approved 7,085 SMSF auditors.

From 31 January 2014, we have begun issuing SMSF auditor annual statements. On the anniversary of their registration, each SMSF auditor will receive a notice from ASIC to let them know that they must lodge their SMSF auditor annual statement. All auditors must complete and lodge an annual statement to verify that they continue to meet the conditions of their registration.

The annual statement will help to ensure SMSF auditors continue to meet the conditions of their registration in line with the Stronger Super reforms. It also forms an important part of maintaining the quality and standard of Australia's SMSF sector. While completing the annual statement, auditors will be asked a series of questions. The questions are similar to those asked

during the original application for registration and will include disclosure of the number of audits completed, compliance against conditions of registration, any applicable disciplinary actions, solvency, and confirmation of understanding of the requirements and obligations as an approved SMSF auditor.

We will use this information to ensure SMSF auditors maintain the standards required by the legislation and meet the conditions of registration. Any non-compliance will be reported quarterly to the ATO.

The auditor annual statement must be completed within 30 days of the anniversary of initial registration as an approved SMSF auditor. If an auditor is unable to complete their statement in this time, they can apply for an extension; however, they must do so before their anniversary date. Completing the annual statement should not take more than 10 minutes, and to help auditors ensure they are aware of what needs to be done and when, we will email additional details to each auditor before their statement is issued. Further information will be available from industry bodies and on our website.

New areas of focus for the SMSF taskforce

The purpose of our SMSF taskforce is to examine high-risk SMSF issues. At the most recent SMSF taskforce meeting, held earlier this month, the taskforce decided to introduce two new areas of focus for 2014:

First, the taskforce will appoint a small project team to explore the trend of ‘one-stop shop’ operators offering a range of services to SMSFs. The project team will investigate the (often complex) business model structures of these operators and the risks to investors that this trend poses. This area of focus comes in response to the recent collapse of Charterhill Group, which operated as a ‘one stop shop’ providing – among other services - advice to clients on establishing SMSFs, rollover of existing superannuation funds into an SMSF, and sourcing and purchase of investment properties.

Second, the SMSF taskforce will expand its work on misleading advertising of SMSFs. At the moment, we regularly identify advertising of SMSFs on websites, print and radio, which do not comply with Regulatory Guidance 234 *Advertising financial products and advice services: Good practice guidance* (RG 234). This work will be expanded to cover online advertising channels, such as Twitter, Facebook and Youtube. We will also be looking at SMSF seminars for evidence of misleading and deceptive conduct, as well any unlicensed financial services conduct. Where we identify any breaches, regulatory action will be sought and we will look to issue an alert to industry and the public to be wary of shonky selling tactics at SMSF seminars.

Future of Financial Advice

On 20 December 2013, the Assistant Treasurer announced Future of Financial Advice (FOFA) reforms. Draft legislation and regulations for these changes were released on 29 January 2014 for public consultation.

Key elements of the reforms include:

- removing the ‘opt-in’ requirement
- removing the retrospective application of the fee disclosure requirement
- removing the ‘catch-all’ provision from the best interest duty
- amending the best interest duty to explicitly allow for the provision of scaled advice
- exempting general advice from conflicted remuneration, and
- amending the grandfathering provisions to allow advisers to move between licensees and to continue to access grandfathering benefits in certain circumstances.

In response, we released a media release on 20 December 2013 indicating that we will not take enforcement action in relation to the specific FOFA provisions that the government is planning to repeal.[2] For example, we will not take action for breaches of the current s962S of the Corporations Act 2001, which requires fee disclosure statements to be provided to retail clients with ongoing fee arrangements entered into before 1 July 2013.

We also reiterated our facilitative approach to FOFA during the first 12 months of operation and we will extend this should the need arise due to the timing of the introduction of the amendments. It is not our intention to take a technical legalistic approach where there is uncertainty.

We wish to provide the financial services industry with as much certainty as possible during the period the FOFA amendments are developed and implemented. As the detail of the amendments becomes available, we plan to make further statements to support a smooth implementation period.

ASIC’s enforcement action

In January, we issued our latest enforcement report which outlined our enforcement outcomes in the second half of 2013.[3] The report includes regulatory outcomes of our SMSF work and a warning to consumers and industry. It is important to note that we are constantly reviewing and monitoring advertising in the SMSF space, and any misleading or deceptive

[2] Media Release (13-355MR) *ASIC Update on FOFA* (20 December 2013).
[3] Report 383 *ASIC enforcement outcomes: July to December 2013* (REP 383).

statements are likely to result in regulatory action as seen in the outcomes below:

- Media Super were issued with an infringement notice after we raised concerns about a factsheet it distributed which inaccurately represented the costs and benefits of Media Super funds compared to SMSFs.
- SMSF Property Capital Pty Ltd paid a $10,200 penalty in response to an infringement notice we issued after making potentially misleading statements about 'ASIC approved' financial products.
- We issued a warning that any real estate agents recommending investors use SMSFs to invest in property must ensure they are appropriately licensed to provide the advice. We are working with the Real Estate Institute of Australia (REIA) to ensure that real estate agents understand their legal obligations.
- In October 2013, we released a warning to consumers about advertisements recommending the purchase of properties through government schemes like the National Rental Affordability Scheme (NRAS). Specifically, we are concerned about advertisements claiming that consumers can use their superannuation to purchase a property using the NRAS and receive '$100,000 tax'. These advertisements do not provide a balanced message about the features, benefits and risks of investing in NRAS property through an SMSF.

Royale Capital matter

The Royale Capital matter arose in response to the promotion to SMSFs of investments in distressed real estate in the United States and funds offered by entities registered in the Virgin Islands.

We commenced proceedings against 18 defendants in the Federal Court of Australia on 28 June 2012, alleging multiple contraventions of financial services laws by Royale Capital, Active Super and associated individuals and companies. Our concerns included:

- unlicensed provision of financial services
- failure to provide disclosure documents to investors
- cold calling practices
- misleading and deceptive conduct, and
- distribution of investor funds to third parties without disclosure to investors.

It is estimated that roughly 350 SMSFs, with investments of approximately $4.75 million, were affected.

There have been a number of court outcomes to date and we have continuing asset preservation and travel restraint orders against some of the defendants. ASIC is now waiting for the court to hand down its decision.

ASIC also investigated the licensee, Spring Financial Group Pty Ltd, which authorised Royale Capital to provide financial services. The investigation resulted in ASIC accepting an enforceable undertaking requiring Spring Financial to engage an independent consultant to review its business and develop a plan to rectify compliance deficiencies, particularly in relation to the monitoring, supervision and training of representatives.

Tarrant matter

The Administrative Appeals Tribunal (AAT) affirmed our decision to ban Mervyn Ross Tarrant from providing financial services for seven years.

Mr Tarrant was the sole director and authorised representative of Tarrants Financial Consultants Pty Ltd, which had invested client funds of more than $23 million in a managed investment scheme promoted by Trio Capital Limited and Shawn Richard.

The AAT found there had been numerous serious and repeated breaches of financial services laws, and that as a consequence of those breaches there had been significant losses to the retirement savings of investors. The breaches included:

- failing to disclose remuneration and benefits derived by Tarrant and his company
- making misleading statements about remuneration and benefits derived by Tarrant and his company, and
- failing to have a reasonable basis for the advice he provided to clients.

Mr Tarrant appealed the AAT's decision. The proceeding was before the Court on 5 February 2014.

Since our investigation of Trio began in October 2009, more than 11 people have either been jailed, banned from providing financial services, disqualified from managing companies or have agreed to remove themselves from the financial services industry for a total of more than 50 years.

Complex products

The second area I would like to touch on is the difficulties complex products can pose for retail investors, an issue that relates directly to our strategic priority of promoting confident and informed investors and financial consumers.

Complex products are products that have structures or particular features that many retail investors find difficult to understand. Examples of products that we currently consider to be complex include structured products, hedge funds, hybrid securities, and leveraged derivative products, such as contracts for difference (CFDs).

The challenge of regulating complex products has been acknowledged by regulators globally. For example, IOSCO recently released a report on the regulation of retail structured products that proposes a number of regulatory tools that regulators could consider using when regulating structured products.[4]

ASIC has conducted reviews of particular complex products to identify areas investors might be facing difficulties. The products we have reviewed include CFDs, hybrid securities and capital protected products. Where appropriate, we have provided further guidance to industry following those reviews – for example, we have released disclosure benchmark guidelines for CFDs

More recently, we have coordinated our attention on this area through a Complex Products Working Group. The group meets regularly, and discusses issues around emerging complex products.

Report on complex products

In January, we published a report on complex products that drew on the work of the Complex Products Working Group.[5] The purpose of the report is to:

(a) initiate further discussion with interested stakeholders on the scope of the risks posed to retail investors by complex products, and the effective management of those risks, and

(b) encourage financial services businesses involved in the development and distribution of complex products, and the provision of financial advice on complex products, to consider the risks outlined in the report in the context of their own business.

Behavioural economics acknowledges that, when faced with complexity, people often tend to simplify the decision-making process. That is, they focus on less relevant but easily assessed criteria, such as advertisements, while neglecting the more relevant, but harder to assess information, such as a product disclosure statement (PDS).

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[4] IOSCO, *Regulation of retail structured products*, report, 20 December 2013.
[5] Report 384 *Regulating complex products* (REP 384).

This can frustrate the effectiveness of disclosure and lends weight to the view that regulators, including ASIC, need to focus their activities across each stage of the product lifecycle.

Product development

The product development stage covers the design and origination of products. This stage is significant in terms of influencing which products enter the marketplace, and which investors acquire those products.

The key risk posed to investors by complex products at the product development stage is that products that are poorly designed enter the market and are offered to investors. This is a risk is attracting greater attention than it has in the past. For example, our work with the Australian Financial Markets Association (AFMA) to develop principles for its members to guide the product development process for retail structured products indicates that we are mindful of the risks posed by complex products during the product development stage, and that where we identify issues relating to the development of particular complex products, we will seek to work with industry to address those issues.

Product distribution

Product distribution is the process through which a product travels from issuer to investor. One of the key risks posed to investors by complex products during the product distribution stage is that inappropriate distribution channels may be used for offering complex products to investors.

We will continue to consider the distribution channels for complex products as part of monitoring the risks posed by these products to investors. Where appropriate, our preference is to work with industry to resolve any issues that arise. For example, in November 2013 we requested that issuers of CFDs and margin foreign exchange (FX) contracts carefully review their distributor relationships to ensure that they are not facilitating the unlawful provision of financial services by any unlicensed distributors.

Another key risk is that disclosure is not clear, concise and effective, or advertising is misleading or deceptive. Providing guidance to industry on disclosure and advertising obligations, and monitoring compliance with those obligations, is a key focus of our regulation of complex products. For example, we have released guidance to help promoters comply with their obligations when advertising financial products and services. We have also conducted a number of surveillances to monitor compliance with these obligations. The outcomes of these surveillances include entities withdrawing or amending promotional materials for retail structured products.

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There is also the risk that investors do not have access to general, independent information on complex products. Investor education is a key aspect in the distribution of financial products because it empowers investors to select products that suit their objectives, financial situation and needs. It also helps investors to better understand how to read disclosure documents, and when to seek financial advice. We do a lot of work in this area, particularly through our MoneySmart website and outreach programs.

Point of sale

The point of sale is usually the point at which advice is given and disclosure is provided, if it has not been provided earlier. Point-of-sale issues relate to whether or not the product is suitable for a specific investor, including their:

- risk appetite
- current financial situation, needs and objectives, and
- experience and understanding of the type of product in question.

The key risk posed to investors by complex products at the point of sale is that the investor might receive poor quality advice, which can result in a poor outcome – or no advice at all, which can result in ill-informed selection of a product.

Our work to improve the quality of financial advice has been, and continues to be, a key focus of our regulatory activities. For example, REP 337 identifies instances where advisers did not communicate the key features and risks accurately to clients. In some cases, advisers may have misrepresented the product as being less complex than it was.

We will also explore the potential of investor self-assessment tools to assist investors to test their understanding of particular products before they invest.

Post sale

Post-sale issues relate to the provision of ongoing information to investors, the resolution of disputes with investors and the provision of compensation where necessary.

A key risk to investors at this stage is that they may not receive ongoing product information, which could be essential to making informed decisions about whether to hold onto or dispose of a product. Where we identify issues relating to the provision of post-sale information to investors for particular complex products, we seek to work with industry to address those issues.

You can access the report and provide feedback to it on our website.