NEW RULES FOR SMSF INVESTMENT STRATEGIES

Many SMSF investment strategies will need to be replaced following legislative changes which occurred in 2012. Failure to do so may result in an Auditor Contravention Report.

In September 2012, the ***Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012***, received Royal Assent - in other words, the provisions of the Act became law.

That followed the introduction of amendments to the SIS Regulations in August 2012, titled ***Superannuation Industry (Supervision) Amendment Regulation 2012 (No. 2)***.

Among the amendments introduced as part of the Act and Regulations were changes which impact the way trustees manage the investment strategies of their SMSFs. Advisers should ensure that SMSF trustee clients are aware of the changes, and the action they should take.

What are the legislative changes?

One of the changes made by the amending legislation was to remove section 52 of the SIS Act '***Covenants to be included in the governing rules***' and insert new sections 52, 52A, 52B and 52C. Effectively, the change divided the old section 52, which catered for **all** regulated superannuation funds, into two parts, being APRA regulated funds, referred to as 'registrable superannuation entities', under the new sections 52 and 52A, and SMSFs (under sections 52B and 52C).

The new sections relevant to SMSFs relate to:

- the covenants which are to be included in the governing rules of SMSFs (s 52B); and
- a covenant relating to directors of the trustee of SMSFs (s 52C) which compels the directors to ensure compliance by the corporate trustee with the covenants in s 52B.

The changes made to the SIS Regs will be dealt with below.

How are SMSFs affected?

The covenants (the 'non-negotiables' of the governing rules of a superannuation fund) underwent a slight but significant change in the conversion from s 52 to s 52B of the SIS Act.

One of the changes is the addition of the words '**review regularly**' at s 52B(f). The change in wording was from the old 'to formulate and give effect to an investment strategy' to the new 'to formulate, review regularly and give effect to an investment strategy'. Subregulation 4.09(2) of the SIS Regs has been similarly amended to contain the words 'review regularly'. Effectively, there was no prior legislative requirement that, once the investment strategy was in place, it be reviewed on any sort of regular basis.

Subregulation 4.09(2)(e) of the SIS Regs was also added, to include the requirement that the trustees **consider** whether the fund should hold insurance cover for members.

It is this change to the SIS Regs which raises the question - '*Are the Investment Strategies of your client SMSFs up to date?*'

Why would they not be up to date?

In prior years, the regular practice regarding the review and replacement of a SMSF investment strategy has tended to have occurred on an ad hoc basis. Often, the investment strategy will have been considered at the time the financial statements for a particular year were being reviewed (i.e. in hindsight).

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An amendment was also possibly required at other times during the course of the year, for example if the trustees decided to change one or more of the fund investments to an asset outside of the investment spread parameters contained in the investment strategy.

Generally, the document did not need to be replaced until such time as the fund investments moved outside of those parameters.

However, investment strategies which were regularly reviewed, but not replaced for some years, will not have contemplated the new legislative requirement that trustees consider whether, in accordance with subregulation 4.09(2), '… the fund should hold a contract of insurance that provides insurance cover for one or more members of the fund.'

Therefore, as it is now necessary for the investment strategy to contain reference to the insurance cover for members of the SMSF, the investment strategy needs to be updated.

What if the investment strategy does not refer to insurance cover for members?

The covenants contained in both the SIS Act and the SIS Regs must be adhered to - they are effectively part of the governing rules of the fund. Without reference to consideration of insurance cover for the members, the trustees have no proof they have complied with that part of the covenants.

As part of their review process, SMSF auditors are required to review compliance, among others, with Reg 4.09 of the SIS Regs, meaning they will need to consider the terms of the investment strategy and whether it meets the requirements of the covenants set down in the SIS Act and Regs. As a breach of Reg 4.09 is a reportable contravention, auditors will be required to complete an Auditor Contravention Report in the event that the investment strategy does not show proof of consideration of insurance cover for members.

SMSF trustees have the power to alter the investment levels of each investment type at any time, but they should ensure that, if they do so, they document the change through either a new investment strategy or an amended investment strategy, as well as trustee minutes.

What does 'review regularly' mean?

Although the term is not defined in either the SIS Act or the SIS Regs, the ATO has indicated that the term 'regularly' will mean at least once every 12 months. The ATO has added the suggestion that consideration also be given to the investment strategy at any other meeting of trustees during the course of the year.

As the consideration regarding insurance cover is not a 'one-off' requirement, the legislative changes effectively mean that the SMSF's insurance position should be reviewed at least annually, with the decisions recorded.

An additional reason why trustees of SMSFs should operate within the parameters of an up to date investment strategy is that the SIS Act, at s 55(5), provides a defense to trustees against actions for loss or damages suffered as a result of an investment decision by the trustees. This defense is only available when the trustees can show that the investment that triggered the litigation was made in accordance with the current investment strategy of the fund, formulated under the investment strategy covenants of sections 52 to 53 of the SIS Act.

Trustee minutes recording the adoption of an investment strategy can be used to show that the investment resulting in the litigation was made in accordance with the investment strategy of the fund, current at that time.

When should we replace the investment strategy?

As the legislative changes were introduced during the 2012/13 financial year, the ideal time to prepare an investment strategy that will meet the new requirements is as soon as

possible in the current financial year.

Remembering that the investment strategy primarily looks to the future, in that it sets investing parameters and considers future cash flow needs, among other issues, preparation and/or review of the document at the start of each financial year is an appropriate strategy.

Investment Strategies for SMSFs - Trustee Obligations

The following notes outline the responsibilities of SMSF trustees in developing and reviewing an investment strategy that conforms with the SIS Act and Regulations.

General Obligations of the Trustees

All trustees of SMSFs are required to prepare, review regularly and implement an investment strategy for their SMSF. When preparing an investment strategy, the trustees must determine the investment objectives of the fund, as well as the investment methods by which the investment objectives will be achieved, based on the following principles:

- To maximise the return to members, taking into account the risks associated with the holding of different types of investments;
- To consider the benefits of diversifying the investments of the fund;
- To ensure the fund has sufficient cash liquidity at any given time to pay member benefits and other costs incurred, as they become payable; and
- To consider whether the fund should hold insurance cover for members.

Trustee Obligation – Determine the Objectives of the Investment Strategy

When preparing the investment objectives of the fund, the trustees must consider many factors that will affect the fund's ability to successfully invest in different types of assets, taking into account the following factors:

1. **The purpose of the fund**

   Is the purpose of the fund to provide lump sum benefits, an income stream, or both, to members?

2. **The circumstances of the fund**

   The circumstances of the fund include:

- The number and age of the members of the fund;
- The retirement plans of each member, and the means by which each member will seek to access their superannuation benefits upon retirement;
- The current cash liabilities of the fund including tax liabilities, expenses in running the fund, the payment of other liabilities, and the payment of member's benefits;
- Anticipated future contributions by the members of the fund;
- The current investment spread of the fund's assets;
- The life insurance needs of the members of the fund; and
- The actual and potential cash liabilities of the fund over the period the trustees are proposing to implement the investment strategy.

Trustee Obligation – Determine the Investment Methods to achieve the Investment Objectives

The SIS Act places certain restrictions on the type of assets that trustees of SMSFs can invest in.

The purpose of placing these restrictions is to protect the fund from exposure to undue risk, and to ensure that the investment decisions made by the trustees are for the sole purpose of generating retirement benefits for the members of the fund, or death benefits for their dependents.

Investment Strategies for SMSFs - The Process

The process to establish an investment strategy for a SMSF is quite straightforward. The main pieces of documentation

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required to complete the investment strategy are:

- the investment strategy document; and
- resolutions considering and, if approved, adopting the investment strategy.

Whilst the resolutions are generally relatively straightforward, the investment strategy document requires a degree of consideration of four main areas, namely:

1. the investment spread across different asset types;
2. the objective from the investment - i.e. the overall investment return;
3. if the fund is intending to purchase assets using SMSF Borrowing arrangements; and
4. whether the fund will hold a contract of insurance for one or more members of the fund.

Investment spread

Well drafted investment strategies will contain a range of parameters, or spread, across a number of asset types. The investment spread generally enables trustees to select a lower amount and a maximum amount the fund might hold for a particular asset type.

Although including a range for each asset type from 0% to 100% will technically meet the requirements to have an investment strategy, such a range for each asset type would indicate that the trustees have not given significant consideration to their obligations under the SIS Act and Regs.

A range of 0% to 100% is often considered to be feasible for cash assets, for example, as it is likely that the trustees may wish to have the ability to, at times, be fully invested out of cash (i.e. in growth assets) and, at other times, to revert fully to cash in the event that they foresee occurrences such as a stock market crash.

Similarly, where trustees intend to invest most of their fund in a property, the percentage held by the fund prior to acquisition will be 0%, but may move close to 100% following purchase. For that reason, a range from 0% to 100% is feasible.

For other assets, the minimum of 0% is justified on the basis that either the fund does not at that stage hold any of that particular asset type, or the trustees wish to retain the right to vacate that asset type at a point in future. However, unless the intent of the trustees is to be fully invested in a particular asset class, it is recommended that maximum levels be set at lower than 100%, based on the risk aversion of the trustees and members and other relevant factors, per asset type.

Investment objective

It is advisable for the trustees to set and investment objective as a benchmark. Usually, such objectives are set over a period of time - for example, a rolling 10 year period. The benchmarks could be an annual percentage range for the investment return, a measurement of a specified percentage above CPI or a specified percentage over and above another similar benchmark, such as annual cash rates.

SMSF Borrowing arrangements

If the trustees intend to enter into a limited recourse borrowing arrangement to acquire an asset, the investment strategy should reflect the intention of the trustees to borrow funds.

Insurance

As required under both the SIS Act and the SIS Regs, the SMSF trustees must consider whether the fund will hold insurance for one or more members. The reasons for deciding to hold or not to hold insurance for any particular member do not necessarily have to be included in the investment strategy. However, a note as to the outcome of the consideration should be included in the investment strategy, so as to confirm the compliance of the trustees with the covenants contained in the SIS Act and Regs.

More information

Should you have any queries or require more information, please contact the team at Topdocs on 1300 659 242.

Current as at 7 August 2013.
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