

# ATO Submission to Parliamentary Joint Committee on Corporations and Financial Services

## Inquiry into the collapse of Trio Capital and any other related matters

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1. The Australian Taxation Office (ATO) welcomes the opportunity to make this submission in response to the Parliamentary inquiry into the collapse of Trio Capital.

### Summary

2. The Australian Taxation Office (ATO) notes that any action to provide a compensation regime to cover Self Managed Superannuation Funds (SMSFs) investments raises a number of issues to be considered. These particularly include:
  - given that SMSF members are also the people who make the investment decisions, the existence of a compensation scheme may have the capacity to influence investment decision making. Specifically, it may impact:
    - investment risk taking, in that greater risk taking may be encouraged; and
    - choice of investment strategy, in that any differentiation between arrangements for SMSFs and individuals may mean that similar assumption of risk may lead to different outcomes;
  - some fund investments may be held in the name of an individual as custodian for a SMSF, and any differentiation between arrangements for SMSFs and individuals may create a need for specific investigation of many claims, and lead to some confusion, and possible disputation. Additionally, many cases are also likely to raise complex evidentiary issues and/or matters of interpretation and application of the law; and
  - the cost of compensation, and its administration, will need to be funded, potentially through an increased levy. Any additional levy costs may lead some trustees who have conservative investment strategies to complain about paying to cover those they consider choose to take greater risk.

### Current superannuation compensation arrangements

3. Prior to the introduction of Superannuation Guarantee (SG) in 1992, retirement saving was not compulsory in Australia<sup>1</sup> and there was no specific compensation scheme for theft and fraud against superannuation funds.
4. As the majority of working Australians were to be subject to mandatory superannuation arrangements the *Superannuation Industry (Supervision) Act 1993* (SISA) was passed to improve the prudential supervision of the superannuation industry.
5. The reforms were aimed at strengthening the security of superannuation savings and protect the rights of members. The Explanatory Memorandum for the *Superannuation Industry (Supervision) Bill 1993* provided details on how financial assistance can be provided to large regulated funds that suffer a loss due to theft or fraudulent conduct. This is covered in Part 23 of the SIS Act 1993.<sup>2</sup>
6. The explanation of Part 23 states:

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<sup>1</sup> <http://www.apra.gov.au/Insight/Documents/History-of-superannuation.pdf>

<sup>2</sup> <http://www.apf.gov.au/library/pubs/bd/2002-03/03bd094.htm#Background>

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391. *“This clause sets out the circumstances under which a large regulated superannuation fund or approved deposit fund that has suffered a loss as a result of fraudulent conduct or theft may apply to the Minister for a grant of financial assistance for the fund.”*

7. From 8 October 1999 excluded superannuation funds had to either nominate to become SMSFs and be regulated by the ATO **or** restructure and become APRA Regulated Funds with independent trustees (now licensed trustees).
8. Part 23 was updated in 1999 from covering large regulated funds to instead cover all superannuation funds excluding SMSFs.
9. **More broadly, the ATO also notes that the Government has** announced a review of the need for, and costs and benefits of, a statutory compensation scheme for financial services. A Consultation Paper was released on this issue in April 2011.<sup>3</sup>

### Background facts about superannuation funds

10. The ATO administers the relevant superannuation laws for SMSFs, works with trustees to help them meet their obligations and verifies compliance. The ATO does not provide financial or investment advice, and does not undertake a prudential role similar to that undertaken by the Australian Prudential Regulation Authority (APRA).
11. SMSF trustees have control over their investment decisions, within restrictions outlined in the SISA, allowing increased flexibility on investment options.
12. There are some 447,000 SMSF's in Australia, two thirds of these have two members and a quarter of these funds only have one member. Total membership is approximately 815,000 people holding about \$432.4 billion in assets which is approximately one-third (32%) of the \$1.357 trillion total in superannuation<sup>4</sup>.
13. There are 4,458 APRA Regulated Funds with 3,869 being Small APRA Funds (SAFs)<sup>5</sup>. SAFs are similar to SMSFs in particular the membership size limitations (maximum of four members). However SAFs are controlled by an independent trustee. Members of SAFs can have input into investment decisions, although unlike SMSFs they have no direct investment control.
14. SMSFs may elect to become a SAF and would then be subject to the higher supervision oversights and increased costs but also would have the compensation coverage provided by Part 23 of SISA.
15. The ATO does not hold statistics on the use of financial planners in making investment decisions. The Investment Trends *SMSF 2010 Investor Report* stated that 65% of SMSFs surveyed indicated that they had used Financial Advisory Services at least once in the past 6 months.
16. Approximately 98% of SMSF's currently use a Registered Tax Agent for their taxation and regulatory affairs. It is likely that a significant proportion of SMSF trustees

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<sup>3</sup> <http://futureofadvice.treasury.gov.au/>

<sup>4</sup> APRA March 2011 Quarterly Statistics

<sup>5</sup> June 2010 Annual Superannuation Bulletin

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investing in entities such as Trio Capital utilised the service of professional third parties in selecting the investment.

### **Investment decision making**

17. Noting that SMSF members are also the people who make the investment decisions, the existence of a compensation scheme may have the capacity to influence trustee behavioural approaches in investment decision making. Particular risks could include lowered concern for 'due care' considerations, and a greater propensity to pursue higher risk short term gains.
18. The ATO's role does not include supervising or determining if investments are appropriate for SMSF members' long term interests. The ATO only determines if an investment strategy is in place and if the investment complies with the legislative requirements in SISA (e.g. a trustee cannot invest in assets for their personal use).
19. The level of investment portfolio risk is a matter for individual trustees. Typically, decreasing levels of risk would be taken with increasing age. That is, trustees would typically seek to weight their portfolio with an appropriate level of risk to ensure that they will have benefits to provide for their retirement. In this regard, industry surveys have regularly listed the leading reason for individuals to choose a SMSF is because they want to have more control.
20. At present, SMSF trustees have access to investment options that large APRA regulated funds have not typically taken, such as collectibles for example. If a compensation scheme were initiated, some examination, and perhaps restriction, of the investment choices available to SMSFs may need to be considered. An increased level of regulatory oversight, with increased compliance and administrative cost, may also be needed.
21. Additionally, noting that SMSF members are also the people who make the investment decisions, any differentiation between arrangements for SMSFs and individuals may lead to change in investment strategies. The assumption of risk is the same in both circumstances, however the potential outcome could differ. The availability of compensation arrangements may cause individuals to hold higher risk investments in SMSFs, and lower risk investments personally.
22. Given the high proportion of superannuation assets that are currently held in SMSFs, any potential change in approach to investment is an issue requiring consideration.

### **Determining who is eligible for compensation**

23. Some fund investments may be held in the name of an individual as custodian for a SMSF.
24. To the extent compensation arrangements differ between SMSFs and individuals there may need to be a specific investigation of each claim, to determine the capacity in which the investment is held. There will also be scope for some confusion, and possible disputation.
25. The range and number of claims potentially made (and the amounts claimed) are likely to be far wider than the particular instances that now arise in relation to APRA

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regulated funds (e.g. potentially involving things such as the apparent theft of items such as wine and art work, which may or may not be insured and may give rise to complex issues of ownership and valuation).

26. Across a large population of people such as SMSF trustees a level of incorrect or inappropriate, and borderline, claims will inevitably arise. The range of matters giving rise to such cases would be expected to include:
- misunderstanding about the criteria for compensation (e.g. claims in relation to 'poor' professional/investment advice are likely – there is a fine line between a 'bad' investment and a fraud);
  - attempts to give the greatest possible scope to the relevant criteria (e.g. would damage or tampering to an asset that reduces its value, perhaps to nil, amount to constructive theft of the value of the item?);
  - where investments take a downturn, experience shows that some individuals can seek to engage in 'game playing' (e.g. given the absence of arms length arrangements between SMSFs and the individuals who run them, some individuals may be seek to interchange assets as between themselves and the fund where differing compensation arrangements apply).
27. The ATO's expectation is that given the potential issues, many cases would raise complex matters of interpretation and application of the law. Additionally, the expectation is that many cases would also raise some difficult evidentiary issues (e.g. determining if losses are due to bad investments or actual fraud or theft)
28. Given the range of potential issues, and the consequent level of investigation likely to be needed on most claims, additional compliance and administrative costs will result.
29. Options for limiting numbers of claims, and associated compliance and administrative costs, could include restricting the types/range of investments potentially subject to compensation, and/or restricting claims only to material amounts over a specified threshold.

### **Other costs issues**

30. Compensation payments received by APRA regulated funds are funded from levies paid by all APRA regulated funds.
31. The cost of compensation, and its administration, will need to be funded, potentially through an increased levy. Increased costs of administration may be substantial, given the likely number and complexity of claims.
32. If an increased levy were to apply, the timing of collection would need to be considered. An ongoing increased levy would be simpler, and cheaper to administer.
33. Some trustees who take a conservative approach to their investments may be unhappy about paying to cover those they consider choose to take greater risk.

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