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Carrying on a business in an SMSF

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Running a business in an SMSF – a rarely discussed aspect

Introduction

There is a certain aspect of an SMSF trustee running a business that is rarely discussed. Admittedly, it rarely comes to fruition. For this reason, I will not discuss it in any detail in my presentation. However, I wanted to use this paper to discuss it, in order to supplement the information provided in my presentation. It must be remembered that when this aspect does come to fruition, it can have a significant negative impact for advisers. Accordingly, it is very important, and advisers should bear it in mind.

It arises typically where an SMSF trustee engages in activities that become speculation rather than investment. Typically this occurs when running a business. More specifically, it typically arises when an SMSF runs a financial instrument trading business involving derivatives.

Before I discuss this aspect in detail, first I wanted to address some more prosaic regulatory issues that often arise from SMSF trustees running financial instrument trading business involving derivatives.

Need for a derivatives risk statement

Firstly, there is a misconception that should be addressed — the misconception that all SMSF trustees holding derivatives require a derivatives risk statement. This is incorrect.

A derivatives risk statement is a statement that sets out:

> policies for the use of derivatives that include an analysis of the risks associated with the use of derivatives within the investment strategy of the fund;
>
> restrictions and controls on the use of derivatives that take into consideration the expertise of staff; and
>
> compliance processes to ensure that the controls are effective (for example, reporting procedures, internal and external audits and staff management procedures).

A derivatives risk statement is not needed merely because an SMSF trustee holds derivatives. Broadly, under regulation 13.15A of the *Superannuation Industry (Supervision) Regulations 1994* (Cth), it is only needed if:

> the SMSF trustee wishes to give a charge (ie, a mortgage, lien or other encumbrance) over its assets; and
>
> that charge is being given in order to comply with the rules of an 'approved body' (eg, the Australian Stock Exchange or the American Stock Exchange).

There are many types of derivatives that do not involve charges over SMSF assets. For example, the Commissioner of Taxation discusses contracts for difference that do not involve charges in ATO Interpretative Decision ATO ID 2007/56. Such contracts for difference would also not necessitate a derivatives risk statement.

Also, a limited recourse borrowing arrangement for real estate would not require a derivatives risk statement (because no charge is being given to comply with the rules of an approved body).

Risk management statement v derivatives risk statement

There is some confusion as to the difference between a risk management statement and derivatives risk statement.

There is no substantive difference between the two. Merely, risk management statements were previously the term for derivatives risk statement. This name changed with effect from 1 July 2004. The change occurred to:

> avoid any potential confusion between the term 'risk management statement', as it was previously designated, and a 'risk management strategy' prepared under section 29H or 'risk management plan' prepared under section 29P [of the *Superannuation Industry (Supervision) Act 1993* (Cth)].

Accordingly, those not wishing to sound like 'old fuddy duddies' should use the term derivatives risk statement.

What the regulators say

APRA agrees that derivatives can play a role in a properly diversified portfolio. They set out their views in Prudential Practice Guide SPG 200. Importantly, APRA state that they consider:

> … it inappropriate for trustees to use derivatives for 'speculation', which … refers to investment activity that results in one or more of the following:
>
> the net exposure of the fund to an asset class being outside the limits set out in the fund's investment strategy. (Net exposure is exposure taking account of both physical and derivative exposure);
>
> the risk involved for the whole portfolio being outside that which the trustee considered appropriate when it developed and approved the fund's investment strategy;
>
> the fund holding uncovered derivatives; and
>
> the fund's total portfolio being 'geared up' through derivatives to circumvent the limitations imposed by ss. 67, 95 and 97 of the SIS Act on borrowings.

Naturally, APRA is not the regulator of SMSFs. The Commissioner of Taxation is the regulator of SMSFs. However, the Commissioner has not released anything as directly on point as APRA's guide. Also, the Commissioner typically tries to be consistent with APRA. Accordingly, APRA's comments should be borne in mind.

What the legislation says

Other than derivatives risk statements (as already discussed), the legislation broadly does not expressly address derivatives.

However, the *Superannuation Industry (Supervision) Act 1993* (Cth) has enshrined certain general law duties and rules in section 52B(2) and these can not be excluded by the trust deed. One such duty is:

> to exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide.

This raises the question of the requisite degree of care, skill and diligence. The seminal case on point states that (*King v Talbot* (1869) 40 NY 76):

> It … does not follow, that, because prudent men may, and often do, conduct their own affairs with the hope of growing rich, and therein take the hazard of adventures which they deem hopeful, trustees may do the same; the preservation of the fund, and the procurement of a just income therefrom, are primary objects of the creation of the trust itself, and are to be primarily regarded.

Although this is a US case and not part of Australian law, it has been cited with approval by Australian judges and incorporated into Australian law. See, for example, *ASIC v AS Nominees Limited* [1995] FCA 1663 [42].

Accordingly, in a roundabout way, the legislation and the case law come to a similar conclusion as APRA. Namely, holding derivatives in an SMSF is allowable for purposes such as hedging against risks. However, they should not be used for speculative purposes and 'speculative purposes' cover a lot of purposes!

Risks to advisers

Sometimes when presenting to financial planners and accountants, I ask for attendees to raise their hands if they have clients who invest using derivatives. A large number of hands are raised. I then ask for hands to stay up if they have clients who make money investing using derivatives. Often almost no hands remain raised.

Accordingly, there is a fair chance that a beneficiary of the fund might be disappointed with the investment performance of the SMSF where using derivatives.

The beneficiary could seek to bring an action. The cause of the action could be that the trustee has failed to exercise the requisite degree of care, skill and diligence by holding derivatives not to hedge but rather to speculate.

In an SMSF it is unusual for beneficiaries to sue trustees, as they are often one and the same. However, it is possible for a beneficiary to sue a third party (eg, the financial planner) if certain criteria are met (*Barnes v Addy* (1874) LR 9 Ch App 244, 251–2). One such set of criteria is as follows:

- breach of duty, even if a totally 'honest' breach (eg, speculating using derivatives);
- some act of assistance or participation (eg, the financial planner advises regarding the derivatives); and
- knowledge of the breach of the fiduciary duty (eg, the financial planner knows of the derivatives).

Note that beneficiaries of SMSFs are a very broad class. They include not just members, but also anyone who might one day benefit. This can include members' children and grandchildren. See *Kafataris v Deputy Commissioner of Taxation* (2008) 172 FCR 242.

Accordingly, if:

- financial planner has the trustee of an SMSF as a client; and
- the trustee holds derivatives for anything that might be seen as speculation;

the financial planner is at risk of being sued by a large class of people.

There is some case law that suggests that even if an SMSF makes money, if a fully diversified 'modern portfolio theory' based investment would have made more money, beneficiaries can sue for the difference. See *Re Mulligan (Deceased)* [1998] 1 NZLR 481 and *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260.

Conclusion

It is possible for SMSF trustees to hold derivatives, even as part of a financial instrument trading business. However, ideally, derivatives should only be used conservatively and not for purposes like speculation. If an adviser has a client who wishes to speculate using derivatives, this will expose the adviser to risk. The adviser should remember this risk and take appropriate steps.