



# TECHNICAL SESSION 3

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Sophisticated investors - swell, rip or wipeout?

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# Sophisticated investors - swell, rip or wipe out?

## SMSFs and the Wholesale and Sophisticated Investor Rules

### Introduction

The sophisticated investor definitions sit within the wholesale investor regime. Application of the relevant tests are one of the ways an investor can be classified as a wholesale investor. Noting that satisfying one of these tests should not be sole mechanism to determine whether it is appropriate to classify a client as a wholesale investor. As professionals, you must consider whether it is in the client's best interests to move them away from the retail client regime. Consideration should also be given to the client's financial literacy and their ability to give true, informed consent.

Whilst there can be advantages for both advisers and clients in stepping outside of the retail client environment, there are also risks for both parties. At first instance, the application of the sophisticated investor rules appears straight forward. However, when we look to the apply those rules in an SMSF context things quickly become complicated. As a result, there are various legal opinions on how aspects of the rules apply in an SMSF context.

NOTE: References to legislation and regulations refer to the *Corporations Act 2001* and the *Corporations Regulations 2001* respectively, unless stated otherwise stated.

### Retail Clients

Under section 761G(1) of the Act, a client will by default be classified as a retail client. That is unless they meet the requirements to be classified as a wholesale client or a sophisticated investor pursuant to s.761G(5), (6), (6A) or (7), or s.761GA.

Classification as a retail client sees both clients and their adviser captured by a range of regulatory obligations under the Act. When dealing with retail clients, the following obligations apply:

- Financial Services Guide (FSG) - 941A
- Statement of Advice (SOA) - 946A, 947B(3)
- Product Disclosure Statements (PDS) - 1012B
- Target Market Determination (TMD) - 994B
- Ongoing fee agreements - 962A, 962R, 962S
- Access to complaints and dispute resolution services (e.g. AFCA) - 912A(1)(g)
- Arrangements for Compensation - 912B

Where a client has acquired a financial product as a retail client, that investment will always remain a retail investment, including its disposal in part or full (s.761G(2) & (3)).

Where SMSFs are concerned, there are certain types of advice that will always be classed as retail advice. Examples include:

1. Establishment of a SMSF
2. Rollovers
3. Contributions
4. Benefit payments
5. Pension products & transfer balance caps
6. Assessment of insurance needs
7. Estate planning
8. Risk profiling
9. Existing investments acquired as a retail client

## Wholesale Client Definitions

A person will be classed as a wholesale client where the financial product or services are not provided or acquired as a retail client (s.761G(4)).

The concept of a wholesale client is not a singular definition or test. Rather, the legislation includes a range of tests that can be applied to determine whether a client is a wholesale investor. Terms such as a 'wholesale client', 'sophisticated investor' or 'professional investor' are tests that are applied under the wholesale client framework set out in section 761G and 761GA of the Act. These are summarised in Appendix 1.

A separate set of sophisticated investor tests reside in section 708(8) of the Act. These tests are expressly limited to the offer of securities. These are summarised in Appendix 2.

Due to the nature of SMSFs, and the types of financial advice, products and services provided to trustees and members, the application of the wholesale investor rules will be limited. As noted in the previous section, certain SMSF advice will always be classified as retail client advice. The application of the wholesale client rules will likely be limited to the provision of investment and financial product advice. This is narrowed further to the offer of securities under the sophisticated investor rules in section 708(8) of the Act.

## SMSFs and the \$10 million net asset test

Challenges arise in applying the above tests in an SMSF context when we consider the application of subsection 761G(6). This is an overarching provision, which states that a financial product or service that is a superannuation product, or relates to a superannuation product or trustee service, will be classed as retail client advice. That is unless, the superannuation fund has net assets of at least \$10 million.

The issue is the lack of clarity on the intent of the phrase '*that relates to*'. It appears that the intention may have been to apply in the context of the acquisition of a superannuation product. Rather than the acquisition of a financial product or service by a superannuation fund (including a SMSF) itself.

It is important to note that ASIC held the view that the \$10 million net asset test would apply in a SMSF context. Until 2014, ASIC's QFS 150 noted that unless that threshold test was met, a trustee of a SMSF would be classed as a retail client.<sup>1</sup>

In media its release 14-191MR, ASIC advised it will not act where an SMSF trustee has been provided services as a wholesale client where the SMSF has net assets of at least \$2.5 million.

It must be emphasised that ASIC's stated approach is not legally binding. It is merely a statement that no compliance action will be taken. A change in the law is needed to provide legislative certainty and clarity. Unfortunately, ASIC has not issued any formal guidance on the application of these tests or addressing issues arising in an SMSF context.

Legislative uncertainty leaves the door open for an aggrieved client to challenge their classification as a wholesale client. Indeed, ASIC warns of this risk and highlights that advisers need to consider their own commercial position and legal risks. Whilst access to AFCA is restricted to a very narrow set of circumstances, a client can take legal action against an adviser and their licensee where a loss is suffered. Similarly, accountants providing accountants certificates should exercise caution.

## SMSFs as Sophisticated Investors

The common method used for classifying a SMSF as a sophisticated investor is via section 708(8)(c) of the Act. Noting that this provision is specifically limited to the offer of securities.

Here a qualified accountant certificate is required, stating that the client has:

1. Net assets of at least \$2.5 million; or
2. Gross income of \$250,000 or more per annum in each of two previous years.

Interestingly, these thresholds are not subject to indexation and have remained frozen in time since their adoption in 2001.

The question then becomes, who satisfies the definition of a 'person' as referred to in section 708(8)(c) of the Act.

The 'person' is the person to whom the offer (to subscribe for securities) is made. In the case of an SMSF, the investor will be the trustee as defined by section 761A of the Act. A superannuation fund, like all trusts does not constitute a legal entity.

At law, the assets of a trust are vested in the trustee as legal, but not beneficial, owner of the assets which are held on behalf of the beneficiaries. In the context of an SMSF, the beneficiaries are the members (or their death benefit beneficiaries).

Section 708(8)(d) of the Act refers to offers made to a company or trust which is controlled by a person who meets the requirements in sub-section 708(8)(c).

The question of 'control' then arises. Section 50AA of the Act says that a person controls a company or a trustee if that person has the capacity to determine the outcome of decisions

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<sup>1</sup> ASIC, 14-191 MR 'Statement on wholesale and retail investors and SMSFs', 8 August 2014, [online] < <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2014-releases/14-191mr-statement-on-wholesale-and-retail-investors-and-smsfs/> >

about the company's or trustee's financial and operating policies. This is a practical test and involves an assessment of the 'practical influence' a person can have, or has had, over decisions.

## Corporate Trustee

Where an SMSF meets the assets test in regulation 6D.2.03, and it has a corporate trustee, the fund will qualify as a sophisticated investor.

## Two Individuals as Trustees

Where there are two individual trustees of an SMSF the assets of the fund are divided across the trustees. As an example, if the SMSF has \$2 million in assets, then technically \$1 million vests in each individual trustee and the SMSF would not qualify under the assets test.

However, if one individual trustee had other assets external to the SMSF which qualified under the assets test, and the total assets of that individual met the requirements of regulation 6D.2.03, the SMSF would qualify as a sophisticated investor.

## Adding a trustee's personal assets to the assets of an SMSF

The assets test in regulation 6D.2.03 requires an individual who is trustee of the SMSF to have at least \$2.5 million in assets. The reason the assets of the fund are not included in the measurement of the individual's assets is that they are not presently entitled to a share of their assets of the SMSF until they vest.

Due to the operation of the preservation rules, present entitlement will not occur until a condition of release has been met. Therefore, the individual's share of the assets in the SMSF are not included in the measurement of their personal assets unless they are entitled to the assets of fund.

Where the SMSF has a corporate trustee, you can not include the gross income or assets of the individual together with the assets of the fund.

ASIC notes that due to a trustee company's fiduciary duties, it will be unable to meet the control test. The trustee company does not own the trust assets and the right of indemnification from trust assets is limited to the liabilities incurred on behalf of the trust.<sup>2</sup>

## Ownership of assets as joint tenants

Assets held as tenants in common have clearly defined ownership rights. However, where an asset is held as joint tenants, each party has an undivided interest in the entire asset. This may apply to jointly owned assets such as real estate owned by a couple.

If the real estate asset was worth \$2 million, each joint tenant would have \$2 million attributed to them as an asset. This may result in each being treated as sophisticated investors where the individual's total assets (including the property) were greater than \$2.5 million.

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<sup>2</sup> ASIC, *Certificates issued by a qualified accountant*, n.d. [online] accessed 27 June 2022 <  
<https://asic.gov.au/regulatory-resources/financial-services/financial-product-disclosure/certificates-issued-by-a-qualified-accountant/>>

However, caution should be applied where the sole or significant asset is the family home, or there is reliance on one jointly held asset to meet the \$2.5 million net asset test. Consider how would this be viewed in the event of a dispute?

## SIS Compliance

The focus so far has been on the application of the rules in the *Corporations Act 2001 and Regulations 2001*. Consideration must also be given to the compliance obligations in the *Superannuation Industry (Supervision) Act 1993 (SISA)*, such as the trustee covenants in SISA section 52B including:

- Exercising care, skill and diligence when dealing the property of another
- To act in the best financial interests of beneficiaries
- Formulating, reviewing, and giving effect to an investment strategy.

Looking at the SMSF's investment strategy, does the investment align with the documented strategy? If not, is it appropriate to amend the investment strategy, considering the risk profiles and needs of all members? Other considerations include:

- How liquid or readily saleable is the asset?
- Have the risk and returns been adequately considered?
- How will the investment affect the fund's level of diversification or lack thereof?
- How will the investment affect the fund's cash flow and ability to discharge its liabilities, including pension payments?
- What are the risk profiles, ages, and stage of life of fund members? Does the fund have pension members?

Where the investment is an unlisted investment, compliance with the asset valuation requirements should also be considered.

## Professional Obligations

### Financial Advisers

Although classifying a client as a wholesale investor can alleviate regulatory burdens for advisers, a duty of care and a fiduciary duty to the client remains. With that in mind, there are some key questions that need to be considered.

Is it appropriate that the fund is invested as a wholesale client in higher risk investments, outside of the retail client framework?

Obtaining an accountant's certificate does not alleviate the legal, professional, and ethical obligations that apply to the adviser. While a client may satisfy the relevant income or asset test, this of itself is not a measure of the client's 'sophistication', knowledge, experience, or appetite for risk.

Is it appropriate and in the clients' best interests?

Will this be in the best interests of all members in the SMSF?

## Professional and ethical obligations

If you are providing services to your clients as both wholesale and retail clients, caution is required to ensure that you comply with the *Financial Planners and Advisers Code of Ethics 2019*.

In its *Financial Planners and Advisers Code of Ethics 2019 - Guide*, the former Financial Adviser Standards and Ethics Standards Authority ("FASEA") provides commentary on the application and intent of the code. Of note are standards 1, 2 and 5 which require advisers to:

1. Act in accordance with applicable laws
2. Act with integrity and in the best interests of each of your clients
3. Ensure your advice is appropriate in the clients' circumstances.
4. Be satisfied that the client understands your advice, the benefits, costs and risks.

The application on the code in the context of wholesale clients is also discussed. The guide encourages advisers to '*exercise professional judgement in considering the clients level of financial literacy and whether they would be more appropriately treated as a retail client.*'<sup>3</sup>

It also highlights that reliance on an accountant's certificates alone is insufficient. Advisers must ask themselves if it is appropriate to classify a client as a wholesale client given their knowledge and experience with financial products, investing and risk.

A further review of a client's circumstances is required when providing new or additional advice to a wholesale client. Is the classification as a wholesale client still appropriate? Do they still meet the requirements?

## Accountants

While the Act has a few ways of determining whether a client is a wholesale client, options requiring an accountant's certificate are popular. This is likely due to the perceived shifting of risk away from the adviser or AFSL. Caution is required, as an accountant may be held liable if a client is later found to have not met the requirements or they seek to argue that they should not have been classified as a wholesale investor and therefore were put at greater risk.

Accountants need to exercise their duty of care and apply professional judgement. Although the preparation of an accountant's certificate is a statement of fact, there are several aspects you should consider.

## Qualified Accountants

The term 'qualified accountant' is not expressly defined in the Act. Instead, section 88B, provides for ASIC to define. ASIC Legislative Instrument *ASIC Corporations (Qualified Accountant) Instrument 2016/786* defines the term 'qualified accountants' as:

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<sup>3</sup> FASEA, '*Financial Planners and Advisers Code of Ethics 2019 - Guide*', October 2020, [online] <<https://webarchive.nla.gov.au/awa/20211213082413/https://www.fasea.gov.au/code-of-ethics-guidance/>>

- Members of the following professional bodies and entitled to use prescribed post nominals:
  - Chartered Accountants Australia and New Zealand – CA or FCA
  - CPA Australia – CPA or FCPA
  - Institute of Public Accountants – AIPA, MIPA or FIPA
  - An eligible foreign professional body and:
    - Have at least three (3) years' experience in accounting or auditing; and
    - Are only providing a certificate for the purposes of section 708(8)(c) and 761G(7)(c) to a person who is a resident in the same country you reside

Further information is also contained in ASIC RG 154 *Certificate by a qualified accountant*.

Ensure that the certificate you are requested to complete is not asking you to attest to matters beyond those prescribed by the legislation. Refer to the sample certificate published by ASIC in their regulatory resource *Certificates issued by a qualified accountant*.<sup>4</sup>

### Professional and ethical obligations

APES 110 *Code of Ethics for Professional Accountants* contains several obligations that must be considered when asked to provide an accountant's certificate, including:

**R111.2** *A Member shall not knowingly be associated with reports, returns, communications or other information where the Member believes that the information:*

- (a) *Contains a materially false or misleading statement;*
- (b) *Contains statements or information provided recklessly; or*
- (c) *Omits or obscures required information where such omission or obscurity would be misleading.*

**R115.1** *A Member shall comply with the principle of professional behaviour, which requires a Member to comply with relevant laws and regulations...*

R120.5 requires the member to exercise professional judgement, remain alert for new information or changes in facts and circumstances, and to use the reasonable, informed third party test.

We recommend that you also refer to your accounting body for further guidance.

Ensure that appropriate records and working papers are prepared and retained to support your assessment.

Accountants should not issue a certificate for a client where it is not appropriate to do so. There will be circumstances where it may be in the clients' best interests to decline the

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<sup>4</sup> ASIC, Regulatory Resource '*Certificates issued by a qualified accountant*', n.d. [online] <<https://asic.gov.au/regulatory-resources/financial-services/financial-product-disclosure/certificates-issued-by-a-qualified-accountant/>>



request of a certificate (including where the client satisfies the relevant income or asset test). Examples include:

- It is not in the clients' best interests
- You don't know the client
- The client does not have the necessary skill, knowledge, or experience
- The client does not understand the implications
- If you are unsure of the client's net assets, gross income, or if they satisfy the tests
- You are being pressured by the client or another party to provide the certificate
- You are unsure for any reason

One area that is often overlooked is professional indemnity insurance. Before agreeing to provide a certificate for a client, you must ensure that your policy will provide cover for this service. If you do not have sufficient cover, you should decline the request for a certificate.

## Appendix 1

### Chapter 7 – Financial Services and Markets

Applicable to a financial product or service that does not relate to a general insurance product, **a superannuation product**, or an RSA product.

Term	Requirements	Corporations Act / Reg
<b>Wholesale Client</b>	The value of the investment-based financial product value equals or exceeds \$500,000.  <i>*Superannuation-sourced money is not to be counted</i>	761G(7)(a)  Reg. 7.1.18 Reg. 7.1.19 Reg. 7.1.26
<b>Wholesale Client</b>	A business that is not a small business.	761G(7)(b)
<b>Wholesale Client</b>	A qualified accountants certificate no more than 6 months* before the offer is made that the person has: a) Net assets of at least \$2.5 million; or b) Gross income for each of the last 2 financial years of at least \$250,000;  <i>[*2 years pursuant to Reg.7.6.02AF]</i>	761G(7)(c) Reg. 7.1.28 Reg. 7.6.02AB Reg. 7.6.02AC
<b>Professional Investor</b>	Includes a person, or a trustee of a superannuation fund with at least \$10 million in net assets	761G(7)(d)
<b>Sophisticated Investor</b>	The AFSL: a) assesses the client's suitability based on the client's previous experience and capability. b) Gives the client a written statement c) Has no other obligations to treat the client as a retail client  Client confirms in writing that the licensee has not given them a PDS or a document required to be given to a retail client	761GA

## Appendix 2

Chapter 6D – Fundraising, Part 6D.2 Disclosure to investors about securities (other than CSF offers).

*Applicable to an offer of a body's securities*

Term	Requirements	Corporations Act / Reg
<b>Sophisticated Investor</b>	A certificate is given by a qualified accountant no more than 6 months before the offer is made that the person has: <ul style="list-style-type: none"> <li>a) Net assets of at least \$2.5 million; or</li> <li>b) Gross income for each of the last 2 financial years of at least \$250,000;</li> </ul>	708(8)(c)  Reg. 6D.2.03
<b>Sophisticated Investor</b>	The offer is made to a company or trust controlled by a person who satisfies 708(8)(c)	708(8)(d)
<b>Sophisticated Investor</b>	The AFSL: <ul style="list-style-type: none"> <li>a) assesses the client's suitability based on the client's previous experience and capability.</li> <li>b) Gives the client a written statement</li> </ul> Client confirms in writing that the licensee has not given them a PDS.	708(10)