

**AUSTRALIAN PRUDENTIAL
REGULATION AUTHORITY**

**SUPERANNUATION CIRCULAR
NO. II.D.5**

**INVESTMENTS TO BE ON AN
ARM'S LENGTH BASIS**

DECEMBER 1998

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IMPENDING CHANGES

The 1998 Budget and the Assistant Treasurer's press release of 28 May 1998 foreshadowed changes covering the transfer of the responsibility for the regulation for certain small funds (currently known as excluded superannuation funds) to the Australian Taxation Office and the tightening of existing investment rules covering all superannuation funds.

These impending changes may impact on the information contained in this Circular and trustees should seek current information on the arrangements and how they apply to each entity's circumstances.

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Objective

1. The aim of this Circular is to explain the rules requiring investments of superannuation entities to be made and maintained on an arm's length basis under the *Superannuation Industry (Supervision) Act 1993* ("SIS").
2. This Circular replaces Superannuation Circular II.D.5 entitled "Investments to be on an Arm's Length Basis" which was released by the former Insurance and Superannuation Commission in October 1994.

Introduction

3. Trustees of superannuation entities are generally free to make properly considered investment decisions that are consistent with their responsibilities for the sound and productive management of assets for the benefit of members and unit holders. However, SIS prohibits or limits certain investment practices which are inconsistent with retirement income policy objectives.
4. These SIS investment restrictions generally help protect and enhance retirement benefits by limiting the exposure of benefits to unnecessary risk. The arm's length investment provision also prevents transactions that may allow fund assets to be used as a source of concessionally taxed benefits to members in pre-retirement years, or to advantage non-members.

The arm's length requirement

Sections 10(1) and, 109

5. All investment transactions of superannuation entities (regulated superannuation funds, approved deposit funds and pooled superannuation trusts) must be made and maintained on an arm's length basis. Transactions need not necessarily be at arm's length (ie. they may be between related or associated parties) but investment transactions must be on an arm's length (commercial) basis.
6. This requirement, in section 109 of SIS, applies to both trustees and investment managers of superannuation entities as both make investment decisions for the entity; the trustee directly and the investment manager under delegation

and instruction from the trustee.

7. An investment manager is a person appointed by a trustee to invest on behalf of the fund or trust, for the purpose of gaining interest, income, profit or gain. Broadly, the investment manager's role is to undertake and manage some or all of the superannuation entity's investments and/or provide investment advice within agreed parameters contained in the written agreement between the trustee and the investment manager.

8. Investments must be entered into and maintained on commercial terms, or on terms that are no more favourable to the other party than would reasonably be expected if the dealing was at arm's length in the same circumstances. For instance the purchase price of an investment should be at market value (or a value more favourable to the fund than to the other party). In addition, the agreed or expected return from that investment should be at not less than a true market rate. All parties to the transaction should seek professional advice on the tax consequences where an investment is made and/or maintained on terms more favourable to the fund than to the other party.

9. The trustee or investment manager must enforce their ongoing rights against a related party in the same manner as they would enforce their rights against any other party. For example, if an employer-sponsor defaults on a loan and appropriate remedial action is not taken then the arm's length requirement would be breached.

10. In addition to the arm's length requirements, any investment undertaken must be part of a properly formulated and implemented investment strategy for the entity as required under section 52(2)(f). Refer to Superannuation Circular II.D.1 "Investment Strategies and Beneficiary Investment Choice" for details.

Meaning of arm's length

Sections 52(2)(f) and 109

11. Whether a transaction is undertaken on an arm's length basis is judged according to all the circumstances of each particular investment. The test to apply is to consider whether a prudent person acting with due regard to their own commercial interests would have made such an investment.

12. In assessing whether a transaction is on an arm's length basis, the trustee or investment manager should consider whether:

- the asking price is a fair price given the expected return on the asset, the risks to which the asset is exposed, and the relative liquidity of the asset;
- the projected returns of income and/or capital are in line with market expectations;
- the contract or agreement adequately protects the interests of the superannuation entity, with clear legal identification of all parties and their rights and obligations;
- valuations have been obtained, where appropriate; and
- any investment in a depreciating asset factors in an amount to recover the depreciation.

13. While none of these considerations alone will necessarily determine an investment as being on an arm's length basis, each could constitute a degree of evidence in support of that inference.

Related and associated parties

Part 8, Sections 65, 66 and Regulation 4.13(2)

14. The arm's length requirement does not necessarily prevent trustees or investment managers from entering into investment transactions with related or associated parties. The requirement applies to the terms of the transaction, not the identity or relationship of the parties. However, the broader investment rules in SIS may prevent or limit such transactions.

15. Section 65 and regulation 4.13 restricts a trustee or investment manager from lending fund money to a fund member or a member's relative. Refer to Superannuation Circular II.D.2. "Lending and Provision of Financial Assistance to Members of Superannuation Entities" for details.

16. Section 66 restricts a trustee or investment manager of a regulated superannuation fund from intentionally acquiring assets from a fund member or member's relative. Refer to Superannuation Circular II.D.3 "Acquisition of Assets from Members" for details.

17. An investment in an in-house asset, where this is permitted under the ‘In-house Asset’ rules in Part 8 of SIS, must also be undertaken and maintained at arm’s length. Refer to Circular II.D.6 “In-house Assets” for details.

18. Although transactions on commercial terms between related or associated parties are acceptable (subject to compliance with the other investment restrictions contained in SIS) trustees and investment managers should ensure there is appropriate documentation to substantiate that the transaction was made and maintained on an arm’s length basis.

Penalties

Sections 109, 193, 196 and 202

19. Significant civil and criminal penalties may apply to trustees and investment managers who contravene the arm’s length provisions.

20. Failure to comply with the arms length rule may also result in the fund becoming a non-complying superannuation fund for taxation and Superannuation Guarantee purposes.