Information sheet for legal practitioners

June 2018

LEGAL PROFESSION Uniform Law

Managed Investment Schemes

Section 258 of the Legal Profession Uniform Law commences on 1 July 2018. The new rules affect the involvement of law practices in the promotion and operation of mortgage practices and other managed investments schemes. They also affect the provision of legal services in connection with mortgage practices.

This Information Sheet explains how the Legal Services Council interprets and applies s 258 of the Legal Profession Uniform Law. It is not a substitute for legal advice, and law practices should carefully consider the application of the Uniform Law and the Rules to their individual circumstances.

The new restrictions for law practices

Section 258 was enacted in 2014, subject to a transition period that ends on 1 July 2018.

Individual solicitors,[i] and incorporated law practices and their related entities,[ii] have been prohibited from conducting a MIS for over a decade.[iii] Section 258 extends that prohibition to all law practices and their related entities. It also covers promoting, not just operating, a MIS.

Specifically, the new restrictions cover:

- law practices and their related entities promoting or operating a managed investment scheme (MIS);
- law practices providing legal services in relation to a MIS in which an associate of the law practice has a substantial interest; and
- law practices providing certain mortgage-related services to private lenders in circumstances where the law practice (or its agent or associate) has introduced the borrower to the lender.

Section 258 was recently amended to include s 258(1A).

Subsection (1A) excludes internal firm arrangements (such as service trusts) from the prohibition.

What is a managed investment scheme?

The Uniform Law adopts the definition of MIS used in s 9 of the *Corporations Act 2001* (Cth). It includes any 'scheme'[iv] that has all three of the following features:

- people contribute money or money's worth as consideration to acquire rights (*interests*) to benefits produced by the scheme (whether the rights are actual, prospective or contingent and whether they are enforceable or not);
- any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits, or benefits consisting of rights or interests in property, for the people (*the members*) who hold interests in the scheme (whether as contributors to the scheme or as people who have acquired interests from holders); and
- the members do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions).

The statutory definition also includes time-sharing schemes. However, it excludes (among other things)[v] bodies corporate, partnerships, franchises, superannuation schemes, and litigation funding arrangements.[vi]

The definition is not limited to schemes that must be registered with ASIC under the Corporations Act.

What does promote mean?

A person promotes a MIS if they formulate and establish the scheme and solicit participants for it or play a significant role in doing so. The concept of promoting a scheme 'plainly extends to activities in which a person formulates a scheme … advertises it, solicits others to participate in it and embarks upon its implementation'.[vii] It has also 'been held to mean a person "who sets up the joint venture and markets it to the investors" and persons

PO Box H326, Australia Square NSW 1215
T +61 8293 5900 F +61 2 8293 5959 E lsc@legalservicescouncil.org.au
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who "engage in exertion for the purpose of getting up and starting a company (or a scheme), and those who assist them"'.[viii] So promoting is used in the sense of getting up the scheme, not in the sense of marketing or advertising it.

What does operate mean?

A person operates a MIS if they do 'acts which constitute the management of or the carrying out of the activities which constitute the managed investment scheme'.[ix] Operate is to be given its ordinary English meaning.[x] It has included a person who had formulated and directed the scheme, was actively involved in the scheme's day to day operations, and supervised others in their performance.[xi] There can be more than one person operating a scheme. In several cases, where a corporation was acting as scheme administrator or manager, its 'directing mind and will' has been found to have been operating the scheme alongside the company.[xii]

A registered MIS (like an ASIC registered mortgage scheme) is operated by its responsible entity,[xiii] which will be a public company holding an Australian financial services licence.

What is a related entity?

The prohibition covers the law practice itself, and its 'related entities'.

If the law practice is a body corporate, then its related bodies corporate (as defined in the Corporations Act) are related entities for this purpose.

In other cases, a related entity is defined in the Uniform Rules along similar lines. A responsible entity (or other MIS promoter or operator that is a body corporate) is a related entity of a law practice if it controls the law practice or is a subsidiary of a body corporate that controls the law practice, or if the law practice:

- controls the composition of its board, or the board of its holding company;
- is in a position to cast or control the casting of more than one-half of the votes at a general meeting of it or its holding company; or
- holds (for example, as partnership property) more than one-half of the voting shares in it or its holding company.

An individual (such as a partner or employee) cannot be a 'related entity' for this purpose because the concept only captures bodies corporate.

Being a director

Section 258(1)(a) does not automatically prohibit an individual solicitor serving as a director of a responsible entity of a registered MIS, or of a corporate operator of an unregistered MIS. But as with all directorships and other business interests outside their legal practice, individual solicitors must manage any potential conflicts of interest appropriately.[xiv]

Acting in relation to MIS in which an associate of the law practice has a substantial interest

Section 258(3) prohibits a law practice from providing legal services to a client (other than the MIS operator) if an associate of the law practice[xv] has a substantial interest in the MIS or its operator.

The restriction applies where the law practice knows, or ought to know through its ordinary conflicts management arrangements, that an associate of the practice has an interest in the MIS or its operator that is so substantial that there is a real and sensible possibility that it may give rise to a conflict of interest and duty. The Rule adopts the test in Rule 8.2 of the Legal Profession Uniform Legal Practice (Solicitors) Rules 2014 so that the restriction applies if an associate of the practice:

- is entitled, at law or in equity, to an interest in the operator or scheme which is significant or of relatively substantial value; or
- exercises any material control over the conduct and operation of the operator or scheme; or
- has an entitlement to a share of the income of the operator or the scheme which is substantial, having regard to the total income which is derived from it.[xvi]

The Council considers that the test of whether an associate of the practice has a substantial interest is intended to be applied objectively; it is whether a reasonable person, having regard to all the circumstances, would consider that the associate's interest or entitlement to be substantial (that is, not trivial or unimportant).

There may be situations in which it is appropriate for a law practice to act for a client that is not the MIS operator despite the associate's interest, but this depends on the circumstances. For example, it may be possible to put in

PO Box H326, Australia Square NSW 1215
T +61 8293 5900 F +61 2 8293 5959 E lsc@legalservicescouncil.org.au
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place adequate arrangements for the management of any potential conflicts arising from the associate's interest using Chinese walls. Section 258(3) allows this to occur if the arrangement is approved by the designated local regulatory authority (DLRA). However, the Council does not consider that merely disclosing to the client that an associate of the law practice may have an interest in the MIS or the operator and obtaining the client's consent is adequate for this purpose.

Mortgage practices

The prohibition contained in s 258(4) of the Uniform Law, prevents a law practice from acting for a lender or contributors (other than a financial institution) in relation to a mortgage when the lender or contributors has been introduced to the borrower by the law practice or an associate, agent or person appointed by the law practice for that purpose. The Rules define 'financial institution' broadly; it means:

- a corporation or other body that is a professional investor within the meaning of s 9 of the Corporations Act;[xvii] and
- a corporation or other body that holds an Australian credit licence under s 35 of the *National Consumer Credit Protection Act 2009* (Cth); and
- a body whose ordinary business includes the lending of money and whose gross assets exceed A$10 million; and
- a body that is a related body corporate, or controls or is controlled by, any of them.

The prohibition in s 258(4) is directed at situations where the law practice, its associate or agent finds and introduces the borrower to private lenders or contributory lenders and then acts for the lender or contributors in relation to the mortgage. It does not apply when the borrower is introduced to the lender or contributors by a credit licensee that is independent of, and not an agent or appointee of, the law practice. This means that law practices can continue to act for lenders or contributors in private (or peer-to-peer) lending arrangements in these circumstances.

Frequently asked questions

I am a sole practitioner. My client has recently inherited and would like to invest the money to produce a steady income stream. My office manager knows a reliable person who wants to take out a mortgage loan to buy a home. It's a one-off thing. Does s 258 apply?

Section 258(1)(a) won't apply, but because of s 258(4) you cannot act for your existing client in relation to the mortgage because she has been introduced to the borrower by an associate of your law practice.

What if, in the above scenario, I contact a mortgage broker to see if they have a suitable borrower for my client?

Section 258(4) won't apply unless the mortgage broker is your associate or agent or you have engaged the broker for the purpose of introducing the borrower to your client. Merely inquiring of the broker does not amount to engaging them.

We are a small country firm that has been winding down our mortgage practice operated under the supervision of the Law Institute of Victoria. How are we affected?

You must complete the winding down or transfer the practice by 1 July 2018.

I am a solicitor in Melbourne. I am a non-executive director on a board of five directors of a responsible entity that operates two registered MIS and four wholesale MIS. How does s 258 affect my firm?

The fact that you are one of five directors does not make your firm a person who is promoting or operating a MIS. As one of five directors, it is unlikely in the ordinary course of business that you individually exercise material control over the conduct and operation of the operator or scheme, so your firm can continue to act for any client in relation to the MIS.

We are a medium sized law practice structured as a partnership that for many decades operated a solicitors' mortgage practice. Fifteen years ago, we transferred operation of the mortgage practice to a responsible entity licensed by ASIC. The responsible

PO Box H326, Australia Square NSW 1215
T +61 8293 5900 F +61 2 8293 5959 E lsc@legalservicescouncil.org.au
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entity is owned and controlled by some of the partners, either directly or through their family trusts. We do the legal work for the MIS. How does s 258 change things for us?

If the MIS has operated independently of the law practice since the responsible entity took over, it is unlikely that the law practice is a promoter or operator of the MIS. The responsible entity is not a related entity of the law practice unless the law practice itself (as distinct from one or more of the partners in their own right) owns or controls it. Of course, if the law practice refers potential investors to the MIS, it must comply with Chapter 7 of the Corporations Act (see ASIC Regulatory Guide 36.74). The law practice can continue to act for the responsible entity in relation to the MIS and the mortgages. However, it cannot act for MIS investors, because some of the practice's associates have a substantial interest in the responsible entity.

What if, in the above scenario, we are an incorporated legal practice and the responsible entity is a subsidiary?

The prohibition in s 258(1)(a) applies because the responsible entity is a related entity of the law practice.

We are a large national firm acting for the vendor in a substantial real estate transaction in which the purchaser is an ASX-listed MIS. It is likely that many of our partners and staff own units in the trust, or shares in the responsible entity or its holding company, either directly or through their superannuation funds. The solicitors working on the transaction have confirmed individually that they are not conflicted. How does s 258 apply?

If the firm knows or ought to know that a partner or staff member has a substantial interest in the responsible entity or the MIS, the firm cannot provide legal services 'in relation to' the MIS. In this case, the Council considers that the firm's services are not provided to the vendor 'in relation to' the MIS; instead they relate to the sale of the property to a purchaser that is the responsible entity of a MIS.

What if, in the above scenario, our firm is acting for a member of the MIS in a dispute with the responsible entity?

If the interest held by the partner or staff member is substantial, this would be prohibited by s 258(3) unless the firm has the approval of the DLRA, for example, because there is a Chinese wall in place.

My father-in-law is a builder, and over the past decade we have jointly put together some small property development syndicates. I also hold a full practising certificate and occasionally do unrelated legal work for people who have invested in the syndicates. How do the changes affect me?

It is likely that you are a promoter of MIS (the property development syndicates); remember the prohibition applies even if the MIS is not required to be registered by ASIC. Your law practice must not promote or operate a MIS, so you need to take considerable care to ensure your private activities are kept scrupulously separate from the law practice. Certainly, you must not act for the client in relation to the syndicate.

How do the changes affect vendor financing?

The Council considers that acting for the vendor or the purchaser in a transaction where there is vendor financing is not within the scope of s 258.

Do the changes affect fidelity fund coverage?

No. Investment arrangements are not covered by the fidelity fund and this remains the case under the new law.

For further information

Legal Services Council
lsc@legalservicescouncil.org.au

+61 2 8293 5900

PO Box H326 Australia Square NSW 1215

[i] Rule 41 of the Rule 41.1 of the Legal Profession Uniform Law Australian Solicitors' Conduct Rules 2015.

[ii] Section 135(2) of the Legal Profession Act 2004 (NSW) and s 170(1) of the Legal Profession Uniform Law Application Act 2014 (Vic).

[iii] Other than small Victorian mortgage practices covered by ASIC Corporations (Mortgage Investment Schemes) Instrument 2017/857.

[iv] That is, a 'coherent and defined purpose, in the form of a "programme" or "plan of action", coupled with a series of steps or course of conduct to effectuate the purpose and pursue the programme or plan': Australian Securities and Investments Commission v Takaran Pty Ltd (2002) 20 ACLC 1,732, 1737.

[v] See paragraphs (c) to (n) of the definition in s 9 of the Corporations Act 2001 (Cth). The drafting is quite specific, and it is important to check exactly what arrangements are excluded from the wide definition.

[vi] Corporations Regulations 2001 (Cth), reg 5C.11.01.

[vii] Australian Securities and Investments Commission v Young (2003) 173 FLR 441 at [53]; see also Australian Securities and Investments Commission v Primelife Corporation Ltd (2005) 54 ACSR 536 at 542; [2005] FCA 1229 at [22]; Re Idylic Solutions Pty Ltd; Australian Securities and Investments Commission v Hobbs [2012] NSWSC 1276 at [1416].

[viii] Re Idylic Solutions Pty Ltd; Australian Securities and Investments Commission v Hobbs [2012] NSWSC 1276 at [1416], referring to Australian Securities and Investments Commission v Infomercial Management Group Pty Ltd [2002] VSC 262 at [35]; Ibrahim v Pham [2005] NSWSC 246 at [316], Australian Securities and Investments Commission v Woods and Johnson Developments Pty Ltd (1991) 6 ACSR 191 at 194.

[ix] Australian Securities and Investments Commission v Pegasus Leveraged Options *Group Pty Ltd* (2002) 41 ACSR 561; [2002] NSWSC 310 at [55] (Davies AJ).

[x] Australian Securities and Investments Commission v Pegasus Leveraged Options *Group Pty Ltd* (2002) 41 ACSR 561; [2002] NSWSC 310 at [55]; Bruce v LM Investment Management Ltd (2013) 94 ACSR 684; [2013] QSC 192 at [12]- [13] (Dalton J).

[xi] Australian Securities and Investments Commission v Pegasus Leveraged Options *Group Pty Ltd* (2002) 41 ACSR 561; [2002] NSWSC 310 at [55]; Re Idylic Solutions Pty Ltd; Australian Securities and Investments Commission v Hobbs [2012] NSWSC 1276 at [1416].

[xii] Re Idylic Solutions Pty Ltd; Australian Securities and Investments Commission v Hobbs [2012] NSWSC 1276 at [1416].

[xiii] Corporations Act 2001 (Cth), s 601FB.

[xiv] Legal Profession Uniform Legal Practice (Solicitors) Rules 2015, Rule 8.1.

[xv] That is, a principal, partner, director, officer, employee or agent of the law practice, or an Australian legal practitioner who is a consultant to the law practice.

[xvi] Rule 8.1 of the Legal Profession Uniform Legal Practice (Solicitors) Rules 2015 imposes certain obligations on a solicitor who 'engages in the conduct of another business concurrently, but not directly in association, with the conduct of the solicitor's legal practice'. A solicitor is taken to engage in the conduct of another business where the solicitor or an associate has a substantial interest in the business as defined in this way.

[xvii] This means a body that: is an Australian financial services licensee; is regulated by APRA (other than a trustee of a superannuation fund, approved deposit fund, pooled superannuation trust or public sector superannuation scheme with net assets of less than $10 million); is registered under the Financial Corporations Act 1974 (Cth); controls at least $10 million (including any amount held by an associate or under a trust that the person manages); is a listed entity, or a related body corporate of a listed entity; is an exempt public authority; carries on a business of investment in financial products, interests in land or other investments and for those purposes, invests funds received (directly or indirectly) following an offer or invitation to the public the terms of which provided for the funds subscribed to be invested for those purposes; or is a foreign entity that, if established or incorporated in Australia, would be included in one of the preceding categories.

PO Box H326, Australia Square NSW 1215
T +61 8293 5900 F +61 2 8293 5959 E lsc@legalservicescouncil.org.au
legalservicescouncil.org.au

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