Report of an inquiry for the Legal Services Council into Section 258 of the Legal Profession Uniform Law

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Declaration of interest

Professor Pamela Hanrahan is a Professor in the School of Taxation and Business Law at UNSW Sydney, a solicitor member of the Law Society of New South Wales and a member of the executive of the Business Law Section of the Law Council of Australia.

Executive summary

This report identifies and explains the likely impact of the commencement of s 258 of the Uniform Law on law practices in Victoria and New South Wales. It recommends that the Council take certain actions to prepare for the commencement of s 258; these are set out in Section 5 of the report and summarised in Annexure D. They include requesting an amendment to s 258(1)(a) and making a number of new Rules to ensure that s 258 is appropriately targeted and does not inhibit the provision of legal services or interfere unduly with the efficient commercial structuring and operation of law practices.

Much of the discussion is technical in nature and reflects the historic concern of the predecessor provisions to s 258 with solicitors' mortgage businesses. The report identifies that s 258 is likely to impact most directly on a relatively small number of firms that retain close ties with mortgage scheme operators through cross-ownerships and directorships, but that it has broader implications (including some that are arguably unintended and that arise from the breadth of the definition of 'managed investment scheme' used in the section).

In broad terms, the report recommends that the restrictions on law practices and their related entities operating 'managed investment schemes' be narrowed so that it only captures managed investment schemes with the character of financial products and does not extend to other private arrangements. It proposes that the restriction on a law practice acting in relation to a managed investment scheme in which an associate has an interest be confined to situations where the practice is acting for a party other than the scheme operator and the associate's interest is substantial and is known (or ought to be known) to the law practice. It also proposes that the restriction on a law practice acting for a lender in relation to a mortgage be restricted to situations where the lender is not a financial sector entity and where the lender has been introduced to the borrower by the law practice or its associate, agent or appointee through mortgage financing activities. Wherever possible, the recommendations have been formulated to reflect and build on other parts of the Uniform Law framework and the applicable financial services law (including Chapters 5C and 7 of the *Corporations Act 2001* (Cth)).

The assistance of the organisations listed in Annexure B and of Ms Sonya Kim of the Legal Services Council in the conduct of the inquiry is gratefully acknowledged.

Section 1 – Introduction

This is the report of an inquiry conducted for the Legal Services Council (Council) into the likely impact of s 258 of the *Legal Profession Uniform Law* (Uniform Law) on law practices in Victoria and New South Wales. Section 258 was enacted in 2014 but its commencement was deferred for a transition period that will expire (unless extended) on 1 July 2018.

The inquiry was commissioned in late June 2017 and reported as at 30 September 2017. The Report was reissued on 20 October 2017 to reflect some further comments made to the inquiry after the reporting date. The terms of reference for the inquiry are set out in Annexure A, and the organisations consulted are listed in Annexure B. The inquiry acknowledges with gratitude the cooperation and candour of the listed organisations in engaging with the inquiry. For ease of reference, the full text of s 258 is extracted in Annexure C to this report.

The operation of s 258 of the Uniform Law is explained in Section 3 below. In essence, it has three limbs, restricting:

- the promotion or operation of managed investment schemes and other similar businesses by law practices or their related entities;
- the provision by law practices of legal services in relation to managed investment schemes in which an associate of the law practice has an interest; and
- the provision by law practices of certain mortgage-related services to lenders in circumstances where the law practice (or its agent or associate) has introduced the borrower to the lender.

Section 258 continues and extends various restrictions on these types of activities by law practices and their associates that have been in place in Victoria and New South Wales since at least 2004. These restrictions, which were in place prior to the commencement of the Legal Profession Uniform Law (referred to throughout as the 'existing restrictions'), and the context in which they were introduced are discussed in Section 2 below.

The inquiry was asked to consider the threshold question of whether s 258 ought to be repealed, or its operation restricted to mortgage investment schemes and mortgage practice. This would have the effect of removing some of the existing restrictions, including the

restrictions on incorporated legal practices and their related bodies corporate conducting managed investment schemes and the requirements imposed on New South Wales practitioners engaged in mortgage practice that have been in place since 2004. The inquiry found no compelling case for relaxing the substance of the existing restrictions. Rather than revisiting this threshold question, most of those with whom the inquiry consulted were more concerned with exploring:

- whether the existing restrictions should be extended in the manner provided for in s 258 of the Uniform Law, and if so to what extent; and
- whether the current drafting of s 258 gives rise to any unforeseen, unintended or unworkable consequences for law practices or their clients that ought to be averted either by law reform or by the exercise of the Council's rulemaking powers.

The above concerns inform the report that follows.

Both the existing restrictions and s 258 impact most obviously on law practices that have a connection with mortgage businesses, as defined in Section 2.1 below. This is because mortgage businesses were historically the most common form of financial intermediation undertaken by law practices; indeed for much of the twentieth century these businesses were a significant component of both the legal profession and the financial sector in Australia. Although most law practices have now ceased their involvement in this type of financial intermediation, some continue. The structure and scale of solicitors' mortgage businesses currently operating in Victoria and New South Wales are discussed in Section 4.1.

While the impact of s 258 on solicitors' mortgage businesses is more obvious, it is important to note that both the existing restrictions and s 258 extend further than this. The potential application of s 258 to other types of structures and activities with which law practices may be connected are discussed in Section 4.2 – 4.4 below.

Any discussion of s 258 raises two fundamental issues that are worth noting at the outset. The first is a policy issue, concerning the extent to which lawyers' involvement in this particular type of business activity ought to be restricted over and above the rules (for example, relating to conflicts or outside business activities) that apply to the profession more generally. The second is a technical issue, concerning the precision with which the drafting in s 258 gives effect to the underlying policy intention. While this technical issue arises with most new legislation, it is particularly acute here because the drafting of s 258(1)(a) picks up

various concepts – including the definition of managed investment scheme in s 9 of the *Corporations Act 2001* (Cth) (Corporations Act) – that are recognised (including judicially) as being open-ended and amorphous. There are some other parts of the section (for example, the use of the term 'responsible entity' in s 258(3)) that also raise questions of statutory interpretation. These technical issues, and the best way to address them, are discussed in Section 5 below.

The report is structured as follows. This Section 1 is introductory. Section 2 explains the existing restrictions and applicable Australian Securities and Investments Commission (ASIC) regulation of the wider managed investments sector. Section 3 outlines the scope of s 258 as enacted, its relationship to the existing restrictions, and the scope of the rulemaking powers under it.

Section 4 presents the inquiry's findings on the likely extent of law practices' involvement in activities covered by s 258. This includes the current size and structure of solicitors' mortgage businesses in Victoria and New South Wales, and a description of other forms of managed investment schemes with which law practices may be connected. This information has been difficult to obtain despite several requests to the professional bodies. On balance, it seems likely that there is a small number of legal practices in Victoria and New South Wales that are promoting or operating solicitors' mortgage businesses, but this activity is no longer widespread. However, given the breadth of the definition of managed investment scheme, the professional bodies have identified other activities routinely engaged in the ordinary course of legal practice that might be caught by the prohibition in s 258(1)(a).

Section 5 contains the central part of the report. It puts forward seven questions for the Council arising from the terms of reference and suggests possible answers to those questions for its consideration (these recommendations are extracted in Annexure D). In answering these questions, it recommends that the Council engage further with the profession on certain matters outlined in the Section.

The remainder of the report is concerned with the future. Section 6 explains the ongoing relationship between s 258 and other provisions of the Uniform Law and Uniform Rules that will continue to apply to law practices in Victoria and New South Wales after s 258 comes into operation on 1 July 2018; these include rules relating to conflicts of interest and the involvement of individual solicitors in business activities outside their legal practice. Section 7 mentions the corresponding restrictions that apply to law practices in other States

and Territories. Section 8 suggests some actions that the Council might take prior to the commencement of s 258 to ensure (as far as possible) a smooth transition in mid-2018, including for law practices currently operating mortgage schemes under the ASIC Class Order relief that is expected to end in September 2018.

Section 2 - The existing restrictions

2.1 Context

For much of the twentieth century, solicitors played an important role in non-bank financial intermediation in Australia. Prior to deregulation of the financial system in the 1980s, the provision of credit by banks was tightly controlled and the opportunity for private investors to access high-yielding fixed interest investments was limited. Solicitors, as the clients' and community's "man (usually) of business", provided an alternative form of financial intermediation. A client with a lump sum to invest, perhaps through the sale of a property or business or a settlement or inheritance, would be matched with a person seeking debt capital who was known to the solicitor and who was able to offer appropriate collateral. The money would be lent on the security of a first mortgage over the borrower's property either by a single lender or a small group of contributory lenders, with the lender or contributors registered as mortgagee on title and the solicitor (in return for a fee) documenting the transaction and collecting and distributing interest and other payments over the term of loan. Some solicitors offered pooled (as distinct from direct or contributory) schemes in which clients' money was pooled in a single fund and lent out to different borrowers, with the solicitor's nominee registered as mortgagee on title, as trustee for the scheme members.

Until 1998, these arrangements were not regulated as part of the financial system; instead they were overseen (to varying degrees) by solicitors' professional bodies. This changed with the commencement in 1998 of the *Managed Investment Act 1998* (Cth) which (among other things) inserted a new Chapter 5C into the Corporations Act. Chapter 5C created a regulatory framework for 'managed investment schemes', the broad statutory definition of which captured these arrangements among many others. Henceforth, unless an exemption applied, a person who operated a managed investment scheme was required to be a public company appropriately licensed by ASIC and to constitute and operate the scheme in accordance with the requirements of the Chapter. This was subject to transitional arrangements. Subsequently a limited exemption was granted by ASIC Class Order for certain small industry-supervised schemes, and this has just been extended by ASIC to September 2018. It relates to a small number of law practices whose remaining mortgage businesses are overseen by the Law Institute of Victoria. These schemes are explained in Section 4.1 below.

By the late 1990s the failure of several solicitors' mortgage businesses, often involving claims on the profession's fidelity funds, had led to a fundamental reassessment of the viability of the sector. Financial system deregulation meant that other forms of non-bank finance were now more readily available. Solicitors' capacity to manage their mortgage businesses was questioned. At this point, the sector split. Some law practices decided to restructure and register their schemes under Chapter 5C of the Corporations Act, and incorporated special purpose public companies (generally owned by the partners or their nominees) to be licensed to act as the responsible entity. These licensed entities were subject to the usual requirements for financial services licensees, including that they have adequate human, financial and technological resources to operate the scheme. Others spun off or sold their mortgage businesses; as Section 4.1 explains, most registered mortgage schemes no longer have any direct connection to law practices. The remainder went into 'run-out' mode, to be wound down as outstanding loans secured by mortgages were repaid.

By 2001 it was apparent that the run-out schemes were in significant difficulty, revealing real structural weaknesses in the underlying business model. In February 2001, ASIC commissioned a report into the run-out schemes by insolvency practitioner Tony Hodgson. In July 2001 it reported that that there were some 6,000 run-out loans held in solicitors' mortgage businesses totalling $1.3 billion. Of these, approximately 50% were in default; default rates ranged from 80% in Queensland to 15% in Victoria. David Knott, then Chairman of ASIC, said in April 2002:

> It always seemed to me that there is something particularly perverse about investment losses from solicitors mortgages. I came from a generation of legal practitioners where mortgage services were an incidental part of a solicitors practice, providing reliable value added to clients of the firm and where losses were strictly limited to rare cases of defalcation. Even now I remain astounded that services provided under the licence of legal practice and the supervision of the legal profession's governing bodies were able to mutate into such high-risk exposures.
>
> With the help of Mr Hodgson we were able to identify a number of recurring features about the schemes. They included:
>
> - a chronic lack of management expertise combined with inexperienced or unqualified personnel;
> - inadequate loan assessment and approval processes;
> - poor default management practices;
> - non-existent, incorrect, inappropriate or exaggerated property valuations;
> - failure to require and/or police prudent loan to valuation ratios; and

- poor, inadequate or misleading disclosure to investors of information material to their investment in the schemes.[1]

The investigations conducted by ASIC led many to conclude that, rather than being better (because of their professional standards and reputation and specialist knowledge) at financial intermediation than financial services firms, solicitors had done a poor job of managing their clients' money. This resulted in a real financial and reputational drain on the whole profession. By the time of the enactment of the new legal profession laws in Victoria and New South Wales in 2004, steps had been taken to ensure that any managed investment scheme in which a solicitor was involved was conducted separately from the law practice, and to exclude money invested in these arrangements from the definition of trust money and from fidelity fund coverage.

2.2 The current position

As at September 2017, the laws regulating the profession in Victoria and New South Wales provide as follows:

1. All solicitors in Victoria and New South Wales must comply with Rule 41.1 of the *Legal Profession Uniform Law Australian Solicitors' Conduct Rules 2015* (Solicitors' Conduct Rules), which will continue to apply alongside s 258 from 1 July 2018.[2] It provides that:

   > A solicitor must not conduct a managed investment scheme or engage in mortgage financing[3] as part of their law practice, except under a scheme administered by the relevant professional association and where no claim may be made against a fidelity fund.

   The exception in Rule 41.1 relates to the small industry-supervised schemes discussed in Section 4.1 below.

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[1] Australian Securities and Investments Commission, *Media Release 02/125 Findings of ASIC's investigation into solicitors' mortgage schemes*, 11 April 2002. See also David Middleton, 'Mortal dangers, moral hazard and mortgage lending by solicitors: an international perspective' (2003) 10 *Journal of Financial Crime* 63-63.

[2] The Law Council of Australia has told the inquiry that Rule 41.1 is proposed to be retained to reflect the law in its current review of the Solicitors' Conduct Rules.

[3] In the Solicitors' Conduct Rules, 'mortgage financing' means facilitating a loan secured or intended to be secured by mortgage by – (a) acting as an intermediary to match a prospective lender and borrower; (b) arranging the loan; or (c) receiving or dealing with payments under the loan, but does not include: (d) providing legal advice, or preparing an instrument, for the loan; (e) merely referring a person to a prospective lender or borrower, without contacting the prospective lender or borrower on that person's behalf or facilitating a loan between family members; or (f) facilitating a loan secured by mortgage: (i) of which an Australian legal practitioner is the beneficial owner; or (ii) held by an Australian legal practitioner or a corporation in his, her or its capacity as the trustee of any will or settlement, or which will be so held once executed or transferred.

2. Incorporated law practices and their related entities in Victoria must continue to comply with s 170(1) of the *Legal Profession Uniform Law Application Act 2014* (Vic) until 1 July 2018. It provides that:

> An incorporated legal practice (or a related entity) must not conduct a managed investment scheme.

Related entity here means a 'related body corporate' within the meaning of s 50 of the Corporations Act.

3. Incorporated law practices and their related bodies corporate in New South Wales must continue to comply with s 135(2) of the *Legal Profession Act 2004* (NSW) until 1 July 2018. It provides that:

> An incorporated legal practice (or a related body corporate) must not conduct a managed investment scheme.

4. Solicitors in New South Wales must continue to comply with Part 3.5 and Schedule 8 of the *Legal Profession Act 2004* (NSW) until 1 July 2018. It deals with mortgage practices and managed investment schemes.

Among other things Part 3.5 prohibits a solicitor who is acting for a lender or contributor from negotiating the making of or acting in respect of a regulated mortgage except in certain limited circumstances. In broad terms a regulated mortgage is one that secures a loan (other than by a financial institution) when the solicitor or an associate has introduced the borrower to the lender.

Part 3.5 allows for a solicitor to act in relation to a registered managed investment scheme in which he or she has an interest (broadly defined). However, if a client entrusts, or proposes to entrust, money to a solicitor to be invested in a registered scheme the solicitor must give the client a notice in writing that advises the client that: (a) the solicitor has an interest in the managed investment scheme; (b) the operation of the managed investment scheme does not form part of the solicitor's practice; and (c) there is no claim against the Fidelity Fund for a pecuniary loss arising from an investment in the managed investment scheme.

Part 3.5 also provides for the operation of State regulated mortgage practices (as defined in s 480 of the *Legal Profession Act 2004* (NSW)) but the Law Society of

New South Wales has indicated that no solicitor's practice has ever nominated itself to be a State regulated mortgage practice.

The Law Society indicated that s 486 of the *Legal Profession Act 2004* (NSW), which operated alongside Rule 41 of the Solicitors' Conduct Rules, appeared to provide clarity to practitioners on their responsibilities and that the Law Society has not been notified of any complaints against solicitors concerning their involvement in a managed investment scheme since the commencement of the *Legal Profession Act 2004* (NSW) in October 2005.

2.3 Relationship with ASIC regulation

The existing restrictions operate in conjunction with the requirements of Chapters 5C and Chapter 7 of the Corporations Act that regulate the formation, offer and operation of managed investment schemes and the provision of financial services by any person in Australia. The following elements of that regulatory regime are particularly relevant to the discussion that follows.

Operating a registerable scheme

Under s 601ED(5) of the Corporations Act, a person 'must not operate … a managed investment scheme that this section requires to be registered [with ASIC] unless the scheme is so registered'. Usually, a managed investment scheme must be registered if it has more than 20 members; if it was promoted by a person, or an associate of a person, who was, when the scheme was promoted, in the business of promoting managed investment schemes; or if ASIC has made a determination that the scheme is one of a group of closely related schemes that between them have more than 20 members. However, a scheme need not be registered if offers of interests in the scheme did not require a Product Disclosure Statement (PDS) under Part 7.9 of the Corporations Act at the time they were made. This carve-out for schemes not offered under a PDS means, in effect, that only schemes that are open to retail investors are required to be registered.

The effect of s 601ED is that most mortgage investment schemes (including contributory and pooled schemes) must be registered with ASIC if they are open to retail investors. To qualify for registration the scheme must have a responsible entity that is a public company holding an Australia financial services licence under Chapter 7 of the Corporations Act, and must meet the various requirements of Chapter 5C. ASIC's regulation

of mortgage investment schemes is explained in ASIC *Regulatory Guide 144 – Mortgage investment schemes* (March 2000). The PDS for a mortgage investment scheme must be prepared in accordance with ASIC *Regulatory Guide 45 – Mortgage schemes: Improving disclosure for retail investors* (May 2012).

The exception applies to small industry-supervised schemes that operate under the relief from the registration requirement given by ASIC Class Order [CO 02/238], the operation of which has recently been extended to September 2018.[4] These schemes are discussed in Section 4.1 below.

Providing financial product advice, and dealing in financial products

Chapter 7 of the Corporations Act regulates the provision of financial services more generally. This includes:

- providing financial product advice (as defined in s 766B of the Corporations Act), and
- dealing in a financial product (as defined in s 766C of the Corporations Act).

Both these concepts are broadly defined.[5] Providing financial product advice includes making a recommendation or statement of opinion that could reasonably be regarded as being intended to influence a person in making a decision in relation to financial products.[6] Dealing includes arranging for a person to acquire or dispose of financial products. Financial products include interests in registered managed investment schemes, as well as interests in some unregistered schemes. There are limited carve-outs for work done in the ordinary

[4] ASIC has indicated to the inquiry that it is likely to extend the relief but the final decision has not yet been published.

[5] See generally, Australian Securities and Investments Commission, *Regulatory Guide 36 – Licensing: Financial product advice and dealing* (June 2016).

[6] For a recent example of a lawyer giving financial product advice in the course of legal practice, see e.g. *De Simone v Legal Services Board* [2017] VSC 471 at [192]. In that case, a lawyer's oral presentation and handing over of documents 'were clearly designed to influence the [client] in making a decision to subscribe for an interest in the Seachange Village project by making their financial contribution and they could reasonably be regarded as being intended to have that effect. The circumstance of [the lawyer] making a presentation at the premises of his practice, that presentation including the provision of a tax opinion prepared by a barrister, along with his firm's general involvement on behalf of [the scheme operator] in connection with the Seachange Village project, is evidence that his promotional activity to [the client] was carried out in his capacity as an associate of the legal practice.'

course of legal practice including under s 766B(5) of the Corporations Act[7] and reg 7.1.35A of the Corporations Regulations 2001 (Cth).

Ordinarily, a person who carries on a business of providing financial services must hold an Australian financial services licence. Lawyers involved in investing money for clients need to be aware of and comply with the requirements of Chapter 7. Merely referring a client to a responsible entity will not usually require a licence, but care must be taken. In some law practices that assist clients with investments identified by the inquiry, individual solicitors have been appointed as authorised representatives of external licensees allowing them to provide these financial services on behalf of the licensee, and this may become more common if the number of interdisciplinary practices increases.

[7] The provision of legal advice is carved-out of the definition of financial product advice, by s 766B(5) of the *Corporations Act 2001* (Cth). It provides, *inter alia*, that 'The following advice is not financial product advice: (a) advice given by a lawyer in his or her professional capacity, about matters of law, legal interpretation or the application of the law to any facts; [and] (b) except as may be prescribed by the regulations--any other advice given by a lawyer in the ordinary course of activities as a lawyer, that is reasonably regarded as a necessary part of those activities'.

Section 3 – Scope of s 258

This Section explains s 258 of the Uniform Law and the Council's rulemaking powers under it. The section itself is extracted in Annexure C.

Section 258 as enacted contains three separate prohibitions. Broadly speaking, these are:

- a prohibition on a law practice (or a related entity) promoting or operating a managed investment scheme (s 258(1)(a), but subject to s 258(2))
- a prohibition on a law practice providing legal services in relation to a managed investment scheme if any associate of the law practice has an interest in the scheme or the responsible entity for the scheme, except as (to be) permitted by the Uniform Rules (s 258(3)), and
- a prohibition on a law practice (or related entity) that is acting as the legal representative of a lender or contributor negotiating the making of or acting in respect of a mortgage where it has introduced the borrower to the lender or contributor, subject to certain exceptions (s 258(4)).

The legislation also allows for the Uniform Rules to proscribe the provision of a service or conduct of a business of a kind (to be) specified (s 258(1)(b)); this is discussed in Section 5.3.

This Section explains the scope of the prohibitions as they currently stand - that is, before the exercise of the various rulemaking powers.

3.1 Promoting or operating a managed investment scheme

The first prohibition is very broad in scope. It applies:

- to a law practice or a related entity of a law practice
- that promotes or operates
- a managed investment scheme.

As is the case under the existing restrictions, 'managed investment scheme' has the same broad meaning in s 258 as it has under the Corporations Act.[8]

Section 2.3 above explains that s 601ED(5) of the Corporations Act prohibits a person from operating a managed investment scheme that ought to be registered with ASIC, but is not. This is narrower than the prohibition in s 258, which prohibits a law practice or a related entity from operating any managed investment scheme, whether registrable or not.

Law practices and their related entities

The prohibition in s 258(1) applies to the law practice itself rather than to individual legal practitioners. 'Law practice' is defined in s 6 of the Uniform Law to include sole practitioners, law firms, community legal services, incorporated legal practices, and unincorporated legal practices.[9]

Both incorporated and unincorporated legal practices may operate as multi-disciplinary practices, so long as they meet the requirements of Div 1, Pt 3.7 of the Uniform Law. The prohibition in s 258, of course, applies to the whole practice in this case. The inquiry did not uncover any law practices that are operating as multi-disciplinary partnerships with wealth management arms, or any law practices that themselves hold Australian financial services licences authorising the law practice to operate a registered or unregistered scheme; this is likely because of Rule 41.1 of the Solicitors' Conduct Rules. If a law practice is part of a multi-disciplinary practice that included a wealth management arm, this would likely fall foul of the prohibition in s 258. The inquiry did hear anecdotal evidence of law practices that share premises with, and work in conjunction with, financial planning businesses but in these cases the two businesses were owned and operated separately.

The prohibition also applies to any 'related entity' of a law practice. If the law practice is a company,[10] its related entities are its holding company, its subsidiaries, and any other subsidiaries of its holding company.[11] This is quite a narrow concept in corporate law; for example, it does not include an officer or a person who controls the company without

[8] Uniform Law, s 6.
[9] These terms are defined in s 6 of the Uniform Law.
[10] That is, an incorporated legal practice or an incorporated community legal centre that is a company.
[11] See *Corporations Act 2001* (Cth) s 50.

being its holding company.[12] If the law practice is not a company, then it falls to the Uniform Rules to define 'related entity' for this purpose (see Section 5.2 below).

One practical implication of the fact that the prohibition in s 258(1)(a) extends to related entities is that a law practice in Australia could not be majority owned by a financial institution (such as a bank) that includes a wealth management arm.

Promote or operate

Section s 258(1)(a) says that a law practice must not 'promote' or 'operate' a managed investment scheme. These words are not defined in the Uniform Law however they have been the subject of judicial interpretation in the context of Chapter 5C of the Corporations Act, including by Ward J in *Re Idylic Solutions Pty Ltd; Australian Securities and Investments Commission v Hobbs* (*Idylic*).[13]

A person **promotes** a managed investment scheme if they formulate and establish the scheme and solicit participants for it, or play a significant role in doing so. In *Australian Securities and Investments Commission* v *Young,* Muir J said that 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'.[14] As Ward J points out in *Idylic*, 'it has also been held to mean a person "who sets up the joint venture and markets it to the investors" and persons who "engage in exertion for the purpose of getting up and starting a company (or a scheme), and those who assist them"'.[15]

A person **operates** a managed investment scheme if they do 'acts which constitute the management of or the carrying out of the activities which constitute the managed investment scheme'.[16] Operate is to be given its ordinary English meaning.[17] In *Australian Securities*

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[12] *Corporations Act 2001* (Cth) s 50AAA contains a definition of associated entities that is considerably broader.
[13] *Re Idylic Solutions Pty Ltd; Australian Securities and Investments Commission v Hobbs* [2012] NSWSC 1276 at [1409] – [1422] (Ward J).
[14] *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].
[15] *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.
[16] *Australian Securities and Investments Commission v Pegasus Leveraged Options Group Pty Ltd* (2002) 41 ACSR 561; [2002] NSWSC 310 at [55] (Davies AJ).

and Investments Commission v Pegasus Leveraged Options Group Pty Ltd, the person found to have operated a managed investment scheme was the 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.[18] There can be more than one person operating a scheme. In several cases where a corporation was acting as scheme administrator or manager, its natural person 'directing mind and will' has been found to have been operating the scheme alongside the company.[19] A registered managed investment scheme is operated by its responsible entity.[20]

An important question in the context of s 258 is when a law practice, rather than an individual lawyer, is operating a scheme. In *De Simone v Legal Services Board (De Simone),*[21] a client of a law firm made a claim against the Victorian fidelity fund in respect of money lost in an unregistered managed investment scheme formed to carry out a property development project. Under the *Legal Profession Act 2004* (Vic) the claim depended in part on whether the law firm was **undertaking** a managed investment scheme. The law firm was operated by a sole practitioner, Brereton, who was also a director of and (through a corporate entity) shareholder in the company operating the scheme, and acted for the operator in certain real estate transactions related to the scheme. The court found that the law firm provided financial product advice to clients about the investment.

At issue in *De Simone* was whether the evidence established that the managed investment scheme was 'undertaken' by Brereton's legal practice. The Board argued that the scheme was undertaken by the practice because, among other things, the Information Report prepared and provided by the practice to the client disclosed that a company in which Brereton was a substantial shareholder was managing the scheme and that Brereton and another man, McLeod, were in effect joint venturers undertaking the managed investment scheme.

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[17] *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).
[18] *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].
[19] *Re Idylic Solutions Pty Ltd; Australian Securities and Investments Commission v Hobbs* [2012] NSWSC 1276 at [1416].
[20] *Corporations Act 2001* (Cth), s 601FB.
[21] *De Simone v Legal Services Board* [2017] VSC 471 (Macaulay J).

Justice Macaulay decided that the evidence did not establish that Brereton's legal practice *undertook* the combination of the three elements that made the project a managed investment scheme. While accepting that Brereton in his capacity as the director and shareholder of his corporate entity — or at least in a personal capacity—was one of two or more persons who, together, undertook the scheme, his Honour found at [201] – [202] that:

> .. the fact that Brereton (the person) played that role and that he was also the sole practitioner of the legal practice does not thereby lead to any logical conclusion that the legal practice necessarily undertook a managed investment scheme … [because on] the evidence, the role of the legal practice was somewhat confined.

In so doing his Honour accepted the plaintiffs' argument that the meaning of 'undertake' should be construed narrowly to conform with the High Court's view that Part 3.6 of the *Legal Profession Act 2004* (Vic) should 'receive as generous a construction as the actual language of those provisions permits'.[22] It was therefore appropriate to construe 'undertaken' as meaning 'performed by' the law firm in this context.

Managed investment scheme

Managed investment scheme in s 258 is defined by reference to s 9 of the Corporations Act. It is:

(a) a scheme that has the following features:

  (i) 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)

  (ii) 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)

  (iii) 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), or

(b) a time-sharing scheme.

The definition goes on to exclude various arrangements from the definition, in paragraphs (c) to (n). These include bodies corporate and partnerships, and arrangements and

[22] *Legal Services Board v Gillespie-Jones* [2013] HCA 35 at [50].

vehicles that are prudentially regulated. There is scope for arrangements that would otherwise be caught to be excluded from the definition by regulation; this was recently done for certain litigation funding arrangements.[23]

There is extensive case law interpreting and applying the definition, from which several key principles emerge.[24] Most important is that paragraph (a) should be interpreted broadly, having regard to 'the literal meaning of the words used in the definition, giving to them any broad application indicated by such a meaning…. [One] should not read down what would otherwise follow from the application of that general approach, by reference to what might be 'the supposedly unintended consequences of a literal reading on everyday commercial transactions'.[25]

The breadth of the definition of managed investment scheme means that a wide range of activities are potentially caught by the prohibition in s 258(1)(a) of the Uniform Law. As noted, it is wider than just arrangements that are registrable with ASIC, or would be registrable but for ASIC relief.[26] This includes:

- solicitors' mortgage businesses,[27] including the mortgage businesses in Victoria that currently operate as small industry-supervised schemes under ASIC Class Order relief;[28]
- other collective investment arrangements, such as property syndicates or investment pools,[29] whether or not they are registerable;

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[23] *Corporations Regulations 2001* (Cth), reg 5C.11.01.
[24] See generally, Pamela F Hanrahan, *Managed Investments Law & Practice* (CCH Australia, loose-leaf at Release [44], 2017) ¶6-100ff.
[25] *Australian Securities and Investments Commission v Emu Brewery Mezzanine Ltd* [2004] 187 FLR 270; [2004] WASC 241 (Simmons J).
[26] The drafting of s 258(3), discussed below, suggests that the intention may have been for the prohibition to apply only to registered schemes. This is because s 258(3) refers to 'the responsible entity for the scheme'; responsible entity is the defined term used in the Corporations Act to refer to the operator of a registered scheme only. However, on a plain reading s 258(1) is not restricted to registered schemes and the Council has previously expressed the view, in its letter to the Law Council of Australia dated 7 April 2017 that the reference to responsible entity ought to be read as a reference to the entity operating the scheme.
[27] Mortgage businesses are managed investment schemes that raise money from participants and invest the money in mortgage loans, usually on either a pooled or a contributory basis. See *Burton* v *Arcus* (2003) 51 ACSR 683 at 687–688. Mortgage investments companies, which are debenture issuing companies with mortgage assets, are discussed below.
[28] This class order is expected to be extended by ASIC to September 2018. See Australian Securities and Investments Commission, *Consultation Paper 287 Remaking ASIC class order on mortgage schemes and proposed relief for multiple withdrawal periods* (June 2017).

- other arrangements falling within the statutory language, even if at first blush they do not look like collective investments. The breadth of the definition is indicated by the decision in *Brookfield Multiplex*,[30] in which a litigation funding agreement was held to be within the definition;[31]

- in certain circumstances, schemes that include or wrap around the issue of debentures or promissory notes;[32] and

- arrangements internal to the law practice itself, including ownership and participation arrangements for partners in law firms that involve trusts.

There is currently no mechanism in the Uniform Law to limit the types of managed investment schemes to which the prohibition in s 258(1)(a) applies, for example through the Uniform Rules. This is considered in Section 5.1 below.

Acting as external administrator

Subsection 258(1) operates subject to s 258(2). It says that, despite s 258(1), an associate of a law practice[33] may promote or operate a managed investment scheme if, in the event of an insolvency or administration of the managed investment scheme, the associate is appointed as:

(a) an administrator, liquidator, receiver, receiver and manager, agent of a mortgagee or controller of the managed investment scheme in respect of the insolvency or administration; or

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[29] The eight main types of registered managed investment schemes available in the Australian market are: unlisted managed funds; listed managed investments (constituted either as exchange-traded funds (ETFs) or listed investment trusts); Australian listed real estate investment trusts (known as A-REITs); unlisted real property schemes; mortgage schemes; infrastructure schemes; agribusiness schemes; and timeshare and serviced strata schemes. Australian Securities and Investments Commission, *Regulation Impact Statement: Holding scheme property and other assets — Update to RG 133* (November 2013) at [19].

[30] *Brookfield Multiplex Ltd v International Litigation Funding Partners Pte Ltd* [2009] 180 FCR 11; (2009) 27 ACLC 1,610; [2009] FCAFC 147.

[31] Some litigation funding schemes and arrangements are now expressly excluded from the definition of managed investment scheme by *Corporations Regulations 2001* (Cth) reg 5C.11.01(b) – (d).

[32] See Hanrahan, above n 24. *Australian Securities and Investments Commission v Emu Brewery Mezzanine Ltd* (2004) 187 FLR 270; [2004] WASC 241.

[33] 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.

(b) a controller or external administrator of an entity acting in a similar capacity as a responsible entity where a managed investment scheme does not have a responsible entity in respect of an insolvency or administration.

This exception, although important in the circumstances in which it does apply, is specific to external administration and is not of wide application.

3.2 Providing legal services in relation to managed investment schemes

The second prohibition, contained in s 258(3), is on a law practice providing legal services in relation to a managed investment scheme if any associate of the law practice has an interest in the scheme or the responsible entity for the scheme, except as (to be) permitted by or under the Uniform Rules, or as approved by the designated local regulatory authority (DLRA).

'Associate' is defined in s 6 of the Uniform Law; it includes the principals, partners, directors, officers, employees and agents of the legal practice (whether lawyers or not), and consultants if they are lawyers.

Section 9 of the Corporations Act defines an 'interest' in a managed investment scheme as 'a right to benefits produced by the scheme (whether the right is actual, prospective or contingent and whether it is enforceable or not)'. There is no definition of 'interest' in the Uniform Law.

'Responsible entity' is a term of art defined in the Corporations Act in connection with registered schemes; it refers specifically to the AFS licensed public company that is so named in the ASIC register. Strictly, an unregistered scheme does not have a responsible entity, at least for Corporations Act purposes. However, the Council has in the past taken the view that the reference to the responsible entity should be read in this context as referring also to the operator of an unregistered scheme. What amounts to an interest in a scheme's responsible entity is not defined, but if it is a company it would likely extend to any legal or equitable interest in the company's securities, including an indirect interest.

It is readily apparent that, in its unmodified form, s 258(3) is very broad. It restricts the provision of legal services to any client, including the scheme operator, in relation to a managed investment scheme[34] where any interest (however small) is held by any associate of

[34] The breadth of the definition of managed investment scheme is discussed in Section 3.1 above.

the law practice. For example, a large national law firm would be prohibited from acting on a matter involving a registered managed investment scheme – say, an Australian Real Estate Investment Trust (A-REIT) or large mutual fund – if any employee owns interests in the scheme or is a shareholder in the financial institution that is or owns the responsible entity.

The legislation provides that a law practice may, however, act in matters permitted by or under the Uniform Rules, or as approved by the DLRA. There is a good case for making Rules to limit the scope of prohibition – this is discussed in Section 5.4 below.

3.3 Negotiating or acting on mortgages arranged by the law practice

The third prohibition relates specifically to mortgage financing businesses, in which a law practice's associate, agent or appointee has introduced the client to the borrower. It restricts the law practice acting for the lender in negotiating or acting in respect of the resulting mortgage.

Specifically, the prohibition is that a law practice (or its related entity) must not, in its capacity as the legal representative of a lender[35] or contributor,[36] negotiate the making of, or act in respect of, a mortgage other than:

- a mortgage under which the lender is a financial institution. Financial institution is defined to include ADIs,[37] and any other 'corporation or other body, or a corporation or body of a class, specified in the Uniform Rules for the purpose of this definition'
- a mortgage under which the lender or contributors nominate the borrower, unless the borrower is introduced to the lender or contributors by the law practice, or by its associate or agent or a person engaged by it for that purpose
- a mortgage, or a mortgage of a class, that the Uniform Rules specify as exempt.

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[35] A lender is a person who lends, or proposes to lend, a borrower money that is secured by a mortgage: Uniform Law, s 258(5).

[36] A contributor is a person who lends, or proposes to lend, money that is secured by a contributory mortgage arranged by a law practice; a contributory mortgage is a mortgage to secure money lent by two or more contributors as tenants in common or joint tenants, whether or not the mortgagee is a person who holds the mortgage in trust for or on behalf of those contributors: Uniform Law s 258(5).

[37] Authorised deposit-taking institutions regulated by APRA – that is, banks, building societies, and credit unions. See http://www.apra.gov.au/adi/Pages/adilist.aspx#PB. It does not include foreign financial institutions taking security over Australian assets, or non-bank lenders regulated by ASIC such as mortgage funds that are registered or exempt managed investment schemes, mortgage investment companies, or other vehicles for the provision of market-based finance.

The rulemaking options relevant to this prohibition are discussed in Section 5.5 - 5.6 below.

Section 4 – Law practices' activities potentially impacted by s 258

This section records the information provided to the inquiry, through the consultations, about the nature and scope of the activities currently undertaken by law practices that may be affected by the commencement of s 258.

The information has been difficult to obtain. This invites two possible conclusions. The first is that most law practices will not be impacted at all by s 258. This is unlikely. The second is that law practices potentially affected by the changes – other than the large law firms represented by Law Firms Australia and a very small number of practices involved in mortgage businesses in Victoria and New South Wales – are not aware of or have not yet engaged with the changes, despite the efforts of the Council, the professional bodies and the inquiry itself to bring them to the profession's attention. If so, this has implications for the Council's further work to ensure a smooth transition, discussed in Section 8.

What follows, therefore, is necessarily incomplete and impressionistic.

Some information shared with the inquiry suggests that the existing restrictions are not always understood or followed. However, the professional bodies and the Designated Local Regulatory Authorities (DLRAs) reported that over the last decade there had been no significant complaints arising out of failure to comply with the existing restrictions. In the absence of any evidence of widespread non-compliance with the existing restrictions, this Section focuses instead on activities that are currently permitted but will (or may, depending on the Council's response to the questions raised in Section 5) be restricted once s 258 commences. The actions suggested in Section 8 may go part of the way to addressing non-compliance, including with Rule 41.1 of the Solicitors' Conduct Rules, resulting from a lack of awareness or understanding of the requirements.

4.1 Mortgage businesses

A significant task of the inquiry was to ascertain the extent to which solicitors' mortgage businesses continue to operate in Victoria and New South Wales. The operation of such businesses may involve the promotion or operation of a managed investment scheme, triggering s 258(1)(a). Where such businesses involve a borrower being introduced to a (non-ADI) lender by the law practice or an associate, agent, or person engaged by the law practice

for that purpose, the law practice may be precluded for negotiating or acting as lawyer for the lender in relation to the mortgage under s 258(4).

The inquiry found that only a small number of law practices remain actively involved in the promotion or operation of mortgage businesses. While this involvement is often very important in financial terms for the individual law practices concerned, it is not a significant component of either the legal profession or the financial sector overall. The law practices with a remaining connection to mortgage businesses fall into four broad groups:

- law practices that conduct small industry-supervised mortgage schemes;
- law practices with close commercial ties to a responsible entity of an ASIC registered mortgage scheme or to the operator of a wholesale mortgage investment scheme;
- law practices that engage in *ad hoc* mortgage financing[38] activities on a small scale, including at the wholesale level; and
- law practices with close commercial ties to a debenture issuing finance company.

Small industry-supervised schemes

The first group is comprised of five Victorian law practices that conduct small industry-supervised schemes under ASIC Class Order [02/238], which was replaced by *ASIC Corporations (Mortgage Investment Schemes) Instrument 2017/587* on 4 October 2017. The number of clients remaining in these schemes (50) and the total amount invested ($5,400,000) is very small. The Law Institute of Victoria has helpfully provided the following information about these schemes:

1. Based on the LIV appointed inspector's previous investigations in the first quarter of 2017, approximately 85 lenders participated in Managed Mortgage Section (MMS) schemes with Mortgage principle outstanding of approximately $10 million. At June 2017 the estimated outstanding balance was $5,400,000 held by (now) five law practices with an estimated 50 lenders involved.
2. Four of the five MMS members listed are old established country Victorian law practices with an aging client base, being self-funded Retirees (direct private clients, family trusts or Super Funds). Most clients would be relying on the mortgage interest income stream, as bank

[38] That is, facilitating a loan secured or intended to be secured by mortgage by: (a) acting as an intermediary to match a prospective lender and borrower, or (b) arranging the loan, or (c) receiving or dealing with payments for the purposes of, or under, the loan.

product interest income is insufficient for their needs. Several loans relate to farm land sales where mortgage loans have been provided by the vendor to the property purchaser. Other undefined investors are also represented.

3. Contributor's average account balance is approx. $110,000, however some high wealth individuals may have $300,000 to $500,000 invested over several mortgage loans.

4. All MMS members were notified by the Law Institute of Victoria in a letter dated 18 September 2015 that law practices will no longer be able to conduct a managed investment scheme and should wind up their MMS Schemes, due to the expiry of the Class Order 02/238 on 1 October 2017 and the prohibition in section 258 of the Legal Profession Uniform Law effective from 1 July 2018.

5. Following this notification, each MMS practice has been visited by the LIV appointed inspector to ensure compliance with the legislation and to assess the status of each MMS scheme in regard to the finalising their schemes by the sunset date.

6. LIV inspections were conducted on 11 MMS practices in the 2015/16 period, being six compliance inspections and five final inspections to confirm the discharge and finalisation of schemes. Remaining practices were inspected again in the 2016/17 period where the current status of these five MMS schemes were assessed. All firms appeared to be working towards finalising their schemes by the sunset dates. The availability of mortgage funds has not been promoted and borrowers and lenders generally had been advised that, due to legislative changes by ASIC (expiry of CO 02/238) and the prohibition of mortgage lending as per section 258 of the Legal Profession Uniform Law, the mortgage schemes would need to be finalised.

7. Most firms remaining in the MMS system appear to have accepted that their mortgage schemes must be finalised by the sunset dates, however some expressed disappointment that a significant component of income would be lost and clients would lose out on the availability of reliable income stream.

8. Following the announcement of the proposed remaking of the Class Order 02/238 in June 2017 and consultations some practices may have slowed finalisation of their schemes and continued/extended loans in the hope of revitalising their mortgage schemes.

9. Inspection Reports prepared by LIV inspectors and distributed to the MMS practices in early 2017 re-iterated the looming sunset date regarding operating managed mortgage schemes and to ensure due dates are prior to 1 October 2017. It was noted that some loan extensions exceeded the class order expiry date and/or the s258 prohibition date, however these appeared to have been extended prior to the notification of the changes in the legislation.

If these arrangements were to continue beyond September 2018, this would require a further extension of by ASIC of the Instrument under which they currently operate.

Law practices with commercial ties to a responsible entity or wholesale mortgage scheme operator

The inquiry identified a small number of law practices that have ties to a responsible entity or operator of a wholesale mortgage investment scheme, beyond the ordinary arms' length relationship between a solicitor and a client. This includes where the responsible entity or operator is directly or indirectly owned by the principals of the law practice, or the majority of its directors are also principals of or appointed by the law practice.

In two Victorian examples identified by the inquiry, it seems that the law practice had responded to the legislative changes in the late 1990s affecting solicitors' mortgage businesses by restructuring those businesses to enable them to be registered with ASIC under Chapter 5C of the Corporations Act, and establishing licensed responsible entities to conduct the schemes. This included putting in place arrangements for ensuring that the responsible entity operated the scheme separately from the law practice, as required by the applicable laws. Some wholesale schemes were also developed; these do not require a responsible entity but the operator of the scheme may (depending on the structure) be required to hold an Australian financial services licence.

In these examples, it appears that the law practice acts for the responsible entity or operator and does the legal work relating to the individual loans made by the scheme. The investors in the schemes may include other clients of the law practice or come from external referrals. The practice may also act for the investor in connection with the investment in some instances. Typically, the borrowers are not clients of the practice but are referred to the responsible entity or operator by third party finance brokers.

In its submission to the Victorian Attorney-General about the impact of s 258 sent in February 2017, the Law Institute of Victoria said, 'The LIV is aware of law practices in which 50% of the practice is concerned with mortgage services, and where the monetary value of offering managed investment schemes and mortgage services is in the vicinity of $20 million'. The Institute has identified two such practices to the inquiry, both of which were included in the consultation, but believes there may be others. In 2008, 19 Victorian responsible entities were members of a (now disbanded) industry group comprised of schemes that emerged from law practices' mortgage businesses. The inquiry estimates that a dozen or fewer of these that retain close commercial ties between the responsible entity and the law practices; the overall trend seems to be towards separation, and the acquisition by

large commercial players (most notably La Trobe Financial) of many such businesses is consistent with that.

In discussions with law practices in New South Wales, the inquiry identified a slightly different structure involving ties between a responsible entity or wholesale scheme operator, and a law practice. In at least one case (and possibly more) the board or management of the responsible entity or operator included an Australian lawyer, who maintained a law practice that did some legal work for the responsible entity or operator but not for investors in or borrowers from the scheme. This included maintaining a trust account so as to be able to participate directly in Property Exchange Australia (PEXA) – an online property exchange network. Again, care was taken to ensure that the two activities were conducted separately consistent with Rule 41.1 of the Solicitors' Conduct Rules.

The inquiry does not consider that the appointment of a lawyer to the board of a responsible entity of itself creates the kind of close commercial ties between the lawyer's law practice and the responsible entity that are discussed here, particularly if the lawyer is a non-executive director and no other associates of their law practice are also on the board. This type of arrangement is common; lawyers have skills and experience that are highly valued by responsible entities and this is and should not be affected by s 258.

Law practices engaging in ad hoc mortgage financing

The inquiry also identified a small number of law practices that undertake mortgage financing from time to time for individual clients on an *ad hoc* basis. Where less than 20 clients are involved, or the clients are wholesale rather than retail investors (typically because the amount lent exceeds $500,000), these activities might not be regulated by ASIC. Nevertheless, if the arrangement comes within the definition of a managed investment scheme it may contravene Rule 41.1 of the Solicitors' Conduct Rules where these activities are not adequately separated from the law practice.

Law practices with close commercial ties to debenture issuers

A final category is worth mentioning. Several law practices in regional Victoria and New South Wales have close commercial ties to public companies that issue debentures to the public by way of prospectus and lend the money invested out on the security of registered mortgages. These include the seven debenture issuers making up the Provincial Financial Group that between them manage over $450 million in investor funds, including over

$336 million lent on security.[39] Several of these companies are co-branded with a law practice. These arrangements are not caught by s 258(1)(a) because they are not managed investment schemes. The possible extension of s 258(1)(b) to these structures is canvassed at Section 5.3 below.

4.2 Conducting other investment-type activities

The inquiry also explored whether law practices often engage in the promotion or operation of other investment-type arrangements that might involve registered or unregistered managed investment schemes. These might include, for example, putting together syndicates to invest directly in real property or business ventures where the law practice's involvement goes beyond the ordinary role of a lawyer providing legal services to an unrelated promoter. The organisations consulted considered this unlikely, although it is clear that individual lawyers may be and are engaged in these kinds of activities outside of their legal practice.[40]

4.3 Involvement in client-led transactions

Some law practices take steps in the structuring and implementation of client-originated transactions that may concern or amount to managed investment schemes. For example, in its submission to the inquiry, Law Firms Australia observed that s 258(1)(a):

> … may also be relevant to securitisation structures given that they often involve unit trusts. On occasion, law firms or related body corporates may, for structuring reasons and at the request of the securitisation sponsor, hold some units in the securitisation unit trust. Whilst LFA is of the view that this would not constitute the law practice promoting or operating a managed investment scheme, it illustrates the point that law firms will sometimes be asked by clients to participate in aspects of structures to facilitate a transaction or series of transactions.

4.4 Internal practice structures

Law Firms Australia also points out that:

> … this prohibition [in s 258(1)(a)] may extend to structures used by many law firms for their own businesses. This includes service trusts and finance trusts which are used to provide non-legal services to firms. Firms would also need to confirm that the definition of 'managed investment scheme' is such that it does not affect any alliance structures, where relevant.

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[39] See https://provic.com.au.

[40] See, for example, *De Simone v Legal Services Board* [2017] VSC 471 discussed in Section 3.1.

4.5 Providing legal services in relation to schemes

Section 258(3) prohibits a law practice providing 'legal services in relation to a managed investment scheme if any associate of the law practice has an interest in the scheme or the responsible entity for the scheme', except as permitted by the Uniform Rules or the DLRA. Unless narrowed by the Rules, this prohibition would affect many law practices. It is worth noting that, as enacted, the prohibition applies in relation to any managed investment scheme as defined (whether registered or not) and regardless of the identity of the client. It is triggered by any interest (not defined) held by any associate (whether directly involved in the matter or not) of the law practice.

4.6 Likely impact on existing arrangements

When s 258 commences, the five remaining law practices that are conducting MMS schemes in Victoria will be required to finalise those schemes. The Law Institute of Victoria informed the inquiry that affected law practices were notified of this in September 2015 and that several schemes would be terminated between 2015 and 2017. There are no such schemes in existence in New South Wales. This will affect the 50 clients whose money is invested in this way, and the corresponding borrowers. The gradual winding down of this type of arrangement in Victoria over recent years does not appear to have left borrowers being unable to refinance (where necessary) on appropriate terms.

The other group of law practices most likely to be directly affected is those that have a commercial tie to a licensed responsible entity operating a registered mortgage scheme. Only three law practices identified themselves to the inquiry as potentially falling within this category although we expect there are more.

The impact of the commencement of s 258 on these law practices depends on the nature of the relationship between the responsible entity and the law practice. As long as they are not 'related entities' then the responsible entities and the schemes will be able to continue to operate as they do currently, and the law practices will be able to continue to do the legal work for the responsible entities on which they rely. However, if they are related entities (because the law practice owns the majority of shares in the responsible entity or controls the composition of the responsible entity's board) they will need to restructure that arrangement to ensure that there is adequate separation between the two entities, and to ensure that the law practice is not a promoter of the scheme.

Some submissions raised concerns that law practices providing legal services to other (unrelated) funds management clients could be affected by s 258, because of the breadth of the various expressions used in the section (including operate, promote, and managed investment scheme). This is unlikely, but the recommended amendment to s 258(1) may alleviate these concerns.

Section 5 – Matters for the Council

The matters discussed in this report give rise to a combination of policy issues and technical issues relating to s 258, and lead ultimately to the following questions for the Council:

1. Should the Council recommend to Government that s 258(1)(a) be amended?
2. How should 'related entity' of an unincorporated legal practice be defined in the Uniform Rules for the purposes of s 258(1)(a) and s 258(4)?
3. What (if any) other services or businesses should be specified in the Uniform Rules for the purposes of s 258(1)(b)?
4. What legal services should be permitted by or under the Uniform Rules for the purposes of s 258(3)?
5. What corporations or other bodies, other than ADIs, should be included in the definition of 'financial institution' in the Uniform Rules for the purposes of s 258(4)(a)?
6. What mortgages should be specified as exempt by or under the Uniform Rules for the purposes of s 258(4)(c)?
7. What guidance or other assistance should the Council give to the profession about s 258 prior to its commencement?

This Section sets out various options and makes recommendations on these questions for the Council's consideration. The inquiry's recommendations are collected in Annexure D.

5.1 Amending s 258(1)(a)

Question 1 is: should the Council recommend to Government that s 258(1)(a) be amended?

Several organisations have submitted that s 258(1)(a) ought to be amended, either to narrow (the policy question) or to clarify (the technical question) its operation. The possibility that the Council might recommend some amendment to s 258(1)(a) has been flagged with Government during the consultation phase.

The first policy question raised by s 258(1)(a) is whether it is necessary to extend the existing restrictions on a solicitor conducting a managed investment scheme as part of their law practice, or on an incorporated law practice or a related body corporate conducting a managed investment scheme, to prohibit any law practice or related entity 'promoting or operating' any managed investment scheme.

Assuming there is no legal difference between 'conducting' and 'operating' a scheme (see below), the real significance of the change is twofold. First, it will restrict law practices' involvement in the **promotion** of managed investment schemes. The concept of 'promoting' a scheme is discussed in Section 3.1 above. It may be, for example, that the law practice in *De Simone*[41] was promoting the scheme, even though it was not undertaking the scheme. In circumstances where there is a close commercial tie between a responsible entity or other scheme operator and a law practice (for example, as discussed in Section 4.1 above) the factual question of whether the law practice is promoting the scheme may be enlivened. Second, the prohibition will now extend to related entities of all law practices, not just incorporated law practices.

The issue for the Council is whether, in its view, law practices or their related entities ought to promote managed investment schemes. At present, this is not prohibited but with the commencement of s 258(1)(a) it will be in future. Some organisations have argued that the existing restrictions have worked well and there is no need to extend them in this way, although the facts in *De Simone* might suggest otherwise.

Law practices with close commercial ties to scheme operators of the kind discussed in Section 4.1 may fall foul of a prohibition on promoting schemes, although ultimately this is a question of fact. If so this would have a significant financial impact on the practices involved and would require the unwinding of long-standing commercial arrangements. These practices argue that the arrangements put in place since the 1990s, including the functional separation of the two businesses as required by Rule 41.1 of the Solicitors' Conduct Rules, are adequate to protect clients and the reputation and integrity of the profession. The inquiry has not uncovered any evidence to suggest this is not correct.

The second policy question is whether the prohibition should cover (as the current restrictions do) to all managed investment schemes as defined, or a narrower subset of them.

[41] *De Simone v Legal Services Board* [2017] VSC 471.

Two options present themselves. The first is to narrow the coverage of s 258(1)(a) to mortgage schemes only, as some organisations have suggested. This is not favoured as it cannot be defended on policy grounds and would merely reflect the historical fact that lawyers' involvement in financial intermediation occurred mostly in this area.

The second is to limit the prohibition to managed investment schemes that have the character of financial products, excluding wholly private or non-commercial arrangements that might otherwise be caught. This could be done, as it is for the purposes of Chapter 7 of the Corporations Act, by using the statutory formulation contained in s 764A(1)(ba) of the Corporations Act.[42] This second option warrants careful consideration and some drafting to give effect to this is suggested below.

As a related matter, if the section is to be amended, it may be prudent to request that Government include a rulemaking power for the Council to allow it to exempt particular schemes from the prohibition in s 258(1)(a) in future. This would help address any unforeseen consequences of the prohibition in a timely way.

The technical question is whether the terms 'promote' and 'operate' need to be defined in the legislation, so as to make it clear that a law practice does not promote or operate a scheme merely because, for example, a principal of the practice is a director of the responsible entity or operator, or the law practice acts for the promoter in establishing a scheme.

They do not. As noted in Section 3.1, these are expressions that have been used in this context in Ch 5C of the Corporations Act for almost 20 years and have been interpreted and applied by the courts on many occasions. It would be undesirable for the Uniform Law to contain a different test from the Corporations Act.

It is noted that the existing restrictions do not define what it means to 'conduct' or 'undertake' a managed investment scheme and this does not appear to have created any undue difficulties in compliance. Of course, it would be open to the Council to address this

[42] The definition of financial product in the Corporations Act includes an interest in a registered scheme (s 764A(1)(b)) and an interest in a managed investment scheme that is not a registered scheme other than a scheme 'in relation to which none of paragraphs 601ED(1)(a), (b) and (c) are satisfied' (s 764A(1)(ba)). Those paragraphs refer to a managed investment scheme that: (a) has more than 20 members; or (b) was promoted by a person, or an associate of a person, who was, when the scheme was promoted, in the business of promoting managed investment schemes; or (c) is the subject of a determination by ASIC that it part of a group of closely related schemes that between them have more than 20 members.

concern by requesting an amendment to s 258(1)(a) to replace 'operate' with 'conduct' to preserve the existing position and ensure consistency with Rule 41.1 of the Solicitors' Conduct Rules, although it is not clear what difference if any there is between the two terms. Given that courts have considered on many occasions what it means to 'operate' a scheme in the context of the Corporations Act, this may be a more certain concept in any event. (In this case, there may be a benefiting in changing Rule 41.1 from 'conduct' to 'operate'.)

Narrowing the scope of the prohibition in s 258(1) so that it does not apply to one-off, private and non-commercial arrangement or to law practices' internal ownership structures and arrangements should strike an appropriate balance. The Council may wish to request that the section be amended to provide as follows:

> (1) Subject to subsection (1A), a law practice (or a related entity) must not--
>
> (a) except as permitted by or under the Uniform Rules, promote or operate a managed investment scheme in relation to which any of paragraphs 601ED(1)(a), (b) or (c) of the *Corporations Act 2001* (Cth) is satisfied; or
>
> (b) provide a service or conduct a business of a kind specified in the Uniform Rules for the purposes of this section.
>
> (1A) Subsection (1) does not prohibit a law practice or a related entity from promoting or operating a scheme that is connected with or related to the business structure, ownership or operation of the law practice.

In Section 8 it is recommended that the Council provide guidance on how it proposes to administer the law, including on its interpretation of the relevant concepts. This should help to allay any legitimate concerns over the new provision. The professional bodies have asked to be involved in preparing the guidance. The guidance should confirm that the Council does not consider that the prohibition captures advice or assistance given to a client in the ordinary course of legal practice in connection with the establishment, operation or termination of a managed investment scheme.

Recommendation 1

The Council should request the following amendments to s 258(1)(a):

- *Add 'except as permitted by or under the Uniform Rules'*
- *Delete 'managed investment scheme' and replace with 'managed investment scheme in relation to which to which any of paragraphs 601ED(1)(a), (b) or (c) of the Corporations Act 2001 (Cth) is satisfied'*

- *Add a carve-out for schemes connected with or related to the business structure, ownership or operation of the law practice itself.*

5.2 Defining 'related entity'

Question 2 is: how should 'related entity' of a law practice that is not an incorporated law practice be defined in the Uniform Rules for the purposes of s 258(1)(a) and s 258(4)?

Section s 258(1)(a) and s 258(4) apply to a related entity of a law practice. Under the Uniform Law, a related entity of an incorporated law practice is defined as a related body corporate within the meaning of s 50 of the Corporations Act: see Section 3.1 above. The definition of related entity for any other law practice is left to the Uniform Rules.

To ensure that all law practices are treated equivalently, the definition in the Uniform Rules should mirror the definition of related entity that is applied to incorporated practices. This could be done by treating the law practice as a body corporate for this purpose and applying the definition of related body corporate in s 50 of the Corporations Act (with appropriate modifications) accordingly.

Using this approach, a responsible entity or other operator would be a related entity of a partnership if the partnership controls the composition of the operator's board, is in a position to cast or control the casting of more than one-half of the votes at a general meeting of the operator, or holds (as partnership property) more than one-half of its voting shares.

Given the context in which the definition of related entity is applied, it is not necessary to extend the net more broadly than this, for example by including in the definition all associates of the law practice.

Recommendation 2

The Uniform Rules should include a definition of related entity for all law practices that reflects the concept of a related body corporate in s 50 of the Corporations Act.

5.3 Proscribing other businesses under s 258(1)(b)

Question 3 is: what (if any) other services or businesses should be specified in the Uniform Rules for the purposes of s 258(1)(b)?

There is no sound policy reason for prohibiting legal practices from engaging in activities that adopt one particular legal structure rather than another but are otherwise economically equivalent.

Therefore, consideration should be given to also proscribing the operation by law practices and their related entities of other investment vehicles that have similar characteristics to managed investment schemes, including debenture issuing finance companies (discussed in Section 4.1 above) and other collective investment vehicles such as superannuation trusts, investment companies, and the foreshadowed corporate collective investment vehicles (CCIVs).[43]

This could be done by including a rule to that effect in the Uniform Rules. However, the inquiry has not consulted with law practices that might be affected by such a rule and a separate round of consultation should be undertaken before this is done.

Recommendation 3

The Council should consult on introducing a Uniform Rule that extends the prohibition in s 258(1)(b) to arrangements that have similar functional characteristics to managed investment schemes, including debenture issuing mortgage finance companies, investment companies, superannuation funds and Corporate Collective Investment Vehicles (CCIVs).

5.4 Permitting legal services in relation to managed investment schemes

Question 4 is: what legal services should be permitted by or under the Uniform Rules for the purposes of s 258(3)?

As enacted, the prohibition in s 258(3) is extremely broad and it is appropriate that it be adjusted in the Uniform Rules. Assuming its purpose is to protect clients (other than the scheme operator itself) in circumstances where the law practice or an associate has a commercial interest in the scheme or operator that may conflict with its obligations to the client, two options are open to the Council.

The **first option** is to carry forward in substance the rule that currently applies in New South Wales under s 486 of the *Legal Profession Act 2004* (NSW). This provision does not

[43] See https://consult.treasury.gov.au/financial-system-division/asia-region-funds-passport/.

prohibit a solicitor from acting where he or she has an interest in a scheme or its operator. Rather it clarifies that the remainder of Part 3.5 does not operate to prevent a solicitor from carrying out any legal service in connection with a managed investment scheme that is operated by a responsible entity, or from having an interest in such a managed investment scheme or in the responsible entity for such a managed investment scheme. Section 486 goes on to provide that if a client entrusts, or proposes to entrust, money to a solicitor to be invested in a managed investment scheme that is operated by a responsible entity, and the solicitor has a prescribed interest[44] in the managed investment scheme, the solicitor must give the client a notice in writing that contains prescribed information.[45]

This option would require a Rule to the effect that a law practice is not prohibited by s 258 from providing legal services in relation to a managed investment scheme even if an associate of the law practice has an interest in the scheme or the responsible entity for the scheme provided that, if the client entrusts money to the law practice to be invested in a scheme in which an associate has a prescribed interest, the law practice must make the required disclosure.

The **second option** is to use the section to impose some restriction on a law practice acting in relation to a managed investment scheme where the law practice knows or ought to know that an associate of the practice has a substantial interest in the scheme or the operator. This would go beyond the ordinary requirements that apply in situations of conflict. A prohibition on acting could be imposed where the law practice is advising a client that is not

[44] Subsection (8) provides that 'a solicitor has a prescribed interest in a managed investment scheme if: (a) the solicitor, or an associate of the solicitor, is a director of or concerned in the management of the responsible entity for the managed investment scheme, or (b) the solicitor, or an associate of the solicitor, is a shareholder in the responsible entity for the managed investment scheme, or (c) the solicitor, or an associate of the solicitor, is taken to be an agent of the responsible entity under Chapter 5C of the *Corporations Act 2001* of the Commonwealth, or (d) the solicitor, or an associate of the solicitor, receives any pecuniary benefit from the managed investment scheme or the responsible entity for the managed investment scheme if a client of the solicitor invests in the managed investment scheme, or (e) the solicitor, or an associate of the solicitor, has an interest of a kind prescribed by the regulations or solicitors rules in the managed investment scheme or the responsible entity for the managed investment scheme'.

[45] The notice must state that: (a) the solicitor has an interest in the managed investment scheme, and (b) the operation of the managed investment scheme does not form part of the solicitor's practice, and (c) there is no claim against the Fidelity Fund for a pecuniary loss arising from an investment in the managed investment scheme.

the scheme operator, and the associate's interest is a substantial one defined along the lines of Rule 8.2 of the *Uniform Legal Practice (Solicitors) Rules 2014*.[46]

The second option would require a new Rule applying the restriction where the law practice knows or ought to know through making reasonable inquiries that an associate:

- 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.

During the consultation, some organisations expressed concern that the test would be difficult to apply because a law practice could not know all of its associates' interests and activities. However, the purpose of linking the drafting of the proposed new Rule to the existing Legal Practice Rule 8 is to ensure that compliance with the new Rule does not require the law practice to make any more inquiry than is already expected of solicitors who must ascertain whether an associate has a substantial involvement in any other outside business, to be able to discharge their obligations under Rule 8. (In fact, the proposed new Rule only applies where the law practice has actual or constructive knowledge of the interest, whereas Rule 8 applies whenever an associate has such an interest.)

The drafting was also queried on the basis that the concepts were 'subjective' although this seems to misunderstand the approach taken in Rule 8 and, by extension, the proposed new Rule. What amounts to a substantial involvement will differ from case to case, although this does not mean the test is subjective. As an alternative it was suggested that the restriction be linked to the control test in s 50AA of the Corporations Act.

On balance, the better approach is for the new Rule to confirm that a law practice is **not** prohibited by s 258 from providing legal services in relation to a managed investment

[46] Rule 8.1 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 to engage in the conduct of another business where the solicitor or an associate has a substantial interest in the business as defined in Rule 8.2.

scheme even if an associate of the law practice has an interest in the scheme or the operator of the scheme **unless**:

- the services are provided to someone other than the operator of the scheme, and
- the law practice knows, or ought to know, that an associate has a substantial interest in the scheme or the operator.

If, as a result of Recommendation 3, other investment vehicles are included under s 258(1)(b), then this Rule should extend to these vehicles also.

This option is preferred over the current s 486 of the *Legal Profession Act 2004* (NSW) because it introduces a level of protection that would, for example, have prevented Brereton from acting for investors in the Seachange Village project when he was a joint venture partner in the company operating the scheme.[47]

Recommendation 4

The Uniform Rules should include a Rule to the effect that, while a law practice is not prohibited by s 258 from providing legal services in relation to a managed investment scheme even if an associate of the law practice has an interest in the scheme or the operator of the scheme, the law practice must not provide the legal services to a person other than the operator if the law practice knows, or ought to know, that an associate has a substantial interest in the scheme or the operator.

5.5 Defining 'financial institution'

Question 5 is: what corporations or other bodies, other than ADIs, should be included in the definition of 'financial institution' in the Uniform Rules for the purposes of s 258(4)(a)?

The effect of including bodies other than ADIs in this definition is as follows: the restrictions in s 258(4) on the law practice acting in relation to a mortgage granted to the body in circumstances where the law practice has introduced the borrower to the body no longer apply.

Again, two options are available. The first is to continue the current position under the New South Wales legislation, which includes various bodies in the definition of financial

[47] *De Simone v Legal Services Board* [2017] VSC 471 discussed in Section 3.1.

institution for the purposes of Part 3.5 of the *Legal Profession Act 2004* (NSW).[48] The second is to take a similar but more expansive approach, using more up-to-date definitions. This would require a Rule that defines financial institution to include:

- a corporation or other body that is a professional investor within the meaning of s 9 of the Corporations Act;[49] and
- a corporation or other body that holds an Australian credit licence under s 35 of the *National Consumer Credit Protection Act 2009* (Cth) (Credit Act); 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,[50] or controls or is controlled by,[51] any of them.

Recommendation 5

The Uniform Rules should include the following corporations and other bodies in the definition of 'financial institution' for the purposes of s 258:

- *a body that is a professional investor within the meaning of s 9 of the Corporations Act; and*
- *a body that is a credit licensee under s 35 of the Credit Act; and*
- *a body whose ordinary business includes the lending of money and whose gross assets exceed $10 million*
- *a related body corporate of, or body that controls or is controlled by, a body referred to above.*

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[48] Section 477 of the *Legal Profession Act 2004* (NSW) includes for this purpose: (a) an ADI, or (b) a body that, immediately before 1 July 1999, was a society within the meaning of the *Friendly Societies (NSW) Code* or a body that is a friendly society for the purposes of the *Life Insurance Act 1995* of the Commonwealth, or (c) a trustee company within the meaning of the *Trustee Companies Act 1964*, or (d) a property trust or other body corporate established by or in respect of a church that may invest money in accordance with an Act, or (e) a corporation or other body, or a corporation or body of a class, prescribed by the regulations for the purpose of this definition.

[49] 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.

[50] Defined by reference to s 50 of the Corporations Act.

[51] Defined by reference to s 50AA of the Corporations Act.

5.6 Exempting mortgages

Question 6 is: what mortgages should be specified as exempt by or under the Uniform Rules for the purposes of s 258(4)(c)?

Section 258(4) is inelegantly drafted. The effect of the section is to prohibit a law practice that is acting for a lender or contributory lender (other than a financial institution) from negotiating or acting in relation to a mortgage in certain circumstances. Those circumstances are:

- where the lender has not nominated the borrower; or
- where the lender has nominated the borrower after being introduced to the borrower by the practice or an associate, agent or person acting for that purpose on its behalf.

The history of the section suggests that it is directed at mortgages arranged as part of mortgage financing[52] engaged in by the law practice or its associate, agent or appointee.

Some firms expressed the concern that the section may prohibit a firm acting for a lender where the borrower had been introduced to the lender by an independent mortgage broker. However, this should not be the case unless the mortgage broker is an associate or agent of the law practice, or a person engaged by the law practice for the purpose of introducing the borrower to the lender or contributors. This should be made clear in the guidance.

Law Firms Australia has expressed concern that this section might apply to mortgages entered into by a client as part of the settlement of a dispute or the implementation of a commercial arrangement where, viewed as a whole, the primary purpose of the transaction of which the mortgage is a part, is not the provision of a loan by the mortgagee to the mortgagor. It is difficult to see how s 258(4) could be triggered in these circumstances.

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[52] In the Solicitors' Conduct Rules, 'mortgage financing' means facilitating a loan secured or intended to be secured by mortgage by – (a) acting as an intermediary to match a prospective lender and borrower; (b) arranging the loan; or (c) receiving or dealing with payments under the loan, but does not include: (d) providing legal advice, or preparing an instrument, for the loan; (e) merely referring a person to a prospective lender or borrower, without contacting the prospective lender or borrower on that person's behalf or facilitating a loan between family members; or (f) facilitating a loan secured by mortgage: (i) of which an Australian legal practitioner is the beneficial owner; or (ii) held by an Australian legal practitioner or a corporation in his, her or its capacity as the trustee of any will or settlement, or which will be so held once executed or transferred.

The Uniform Rules should specify that the restriction on acting for a lender that is not a financial institution only applies when the law practice or an associate, agent or appointee of the law practice has introduced the borrower to the lender as part of its mortgage financing activities. The definition of mortgage financing should reflect Rule 41.1 of the Conduct Rules. The structure of s 258(4)(c) means that this must be done by specifying a class of mortgages as exempt from the prohibition.

Recommendation 6

The Uniform Rules should provide that the prohibition only applies where the lender or contributor has been introduced to the borrower by the law practice or an associate, agent or appointee of the law practice engaged in mortgage financing as defined in the Conduct Rules.

5.7 Providing guidance

Once the Council has made an in-principle decision about requesting any amendment to s 258 and on the Uniform Rules, it will be appropriate to consult further with the profession.

Assuming the matters raised in this section are dealt with in a timely way, the inquiry does not see the need to defer the commencement of s 258 beyond 1 July 2018. However early in 2018 the Council should prepare and provide a guidance note explaining its approach to interpreting and applying s 258 for the benefit of the profession. This should include worked examples of structures and activities that the Council considers are or are now allowed under the section. It should also explain how the restrictions in s 258 interact with other provisions of the Uniform Law and Rules and with fidelity fund and professional indemnity insurance arrangements, discussed in Section 6.

Recommendation 7

The Council should prepare and publish a guidance note explaining the restrictions that will imposed by s 258, giving examples of conduct that is or is not proscribed. The note should explain the interaction between s 258 and other relevant provisions of the Uniform Law and the Uniform Rules (including provisions relating to conflicts, other business activities and fidelity fund cover) and law practices' professional indemnity insurance cover. The guidance note should be provided to the professional bodies for comment before it is published.

Section 6 – Other relevant rules and restrictions

Section 258(1)(a) will prohibit a law practice or a related entity of a law practice from operating a managed investment scheme (or, if Recommendation 1 is adopted, managed investment schemes with the character of financial products).

The prohibition does not extend to individual solicitors, whose conduct in this regard is regulated by Rule 41.1 of the Solicitors' Conduct Rules. That Rule allows an individual solicitor to conduct a managed investment scheme otherwise than as part of their law practice. If an individual solicitor does so, the following other rules and considerations remain relevant.

6.1 Other business activities of individual practitioners

The *Legal Profession Uniform Legal Practice (Solicitors) Rules 2015* recognise that individual legal practitioners may have business activities and roles outside their legal practice. Under Rule 8.1, a solicitor who engages in the conduct of another business[53] concurrently, but not directly in association, with the conduct of the solicitor's legal practice must observe certain restrictions. They must:

- ensure that the other business is not of such a nature that the solicitor's involvement in it would be likely to impair, or conflict with, the solicitor's duties to clients in the conduct of the practice;
- maintain separate and independent files, records and accounts in respect of the legal practice and the other business;
- disclose the solicitor's financial or other interest in that business to any client of the solicitor who, in the course of dealing with the solicitor, deals with the other business; and
- cease to act for the client if the solicitor's independent service of the client's interest is reasonably likely to be affected by the solicitor's interest in the other business.

[53] Rule 8.2 says that, for this purpose, a solicitor is taken to engage in the conduct of another business where the solicitor, or an associate is entitled, at law or in equity, to an interest in the assets of the business which is significant or of relatively substantial value, exercises any material control over the conduct and operation of the business, or has an entitlement to a share of the income of the business which is substantial, having regard to the total income which is derived from it.

Of course, this is in addition to a legal practitioner's broader obligations (including fiduciary obligations) arising in situations of conflicts of interest and duty, or conflicts of duty.

6.2 Fidelity fund coverage

Investment moneys received by lawyers are excluded from the definition of trust moneys under s 129(2) of the Uniform Law.[54] Losses in this area are not covered by the fidelity fund, because of Part 4.5 of the Uniform Law.

6.3 Professional indemnity insurance

It is worth noting that the professional indemnity insurance available to law practices typically excludes cover for claims arising out of the provision of financial services;[55] that cover must be obtained separately.[56]

[54] Section 129(2)(b) excludes from the definition money entrusted to or held by a law practice for or in connection with a managed investment scheme or mortgage financing undertaken by the law practice. 'Mortgage financing' means facilitating a loan secured or intended to be secured by mortgage by acting as an intermediary to match a prospective lender and borrower, arranging the loan, or receiving or dealing with payments for the purposes of, or under, the loan but does not include providing legal advice or preparing an instrument for the loan. Section 129(2)(c) excludes money received by a law practice for or in connection with a financial service it provides in circumstances where the law practice or an associate of the law practice is required to hold an Australian financial services licence covering the provision of the service provides the financial service as a representative of another person who carries on a financial services business.

[55] For example, the Lawcover sample professional indemnity insurance policy for law practices (including multi-disciplinary practices) in New South Wales for 2017/18 excludes, at paragraph 9(iii) claims arising out of 'any activity that constitutes the provision of a financial service under the *Corporations Act 2001* (Cth) Chapter 7 (other than an activity that constitutes a referral under the *Corporations Regulations 2001* Regulation 7.6.01(e)) or that constitutes the provision of a credit facility, as defined in the *Corporations Regulations 2001*'. The LPLC policy for solicitors in Victoria excludes a range of claims under clause 20, including liability as a responsible entity, or liability arising from an insured providing a financial service in respect of which the insured was licensed or authorised under Chapter 7 of the *Corporations Act 2001* (Cth). It also excludes liability to a Related SMIC, arising from any investment or dealing or advice, representation, recommendation, endorsement or opinion favouring investment in any managed investment scheme operated by any Related SMIC or investment by way of a deposit with or loan to a Related SMIC, or arising in any way from the operations of a Related SMIC. An SMIC (Solicitors Mortgage Investment Company) is an entity that carries on an investment business or a business of the provision of finance to the public (whether on the security of mortgages over real estate or otherwise).

[56] AFS licensees must have appropriate insurance under *Corporations Act 2001* (Cth) s 912B.

Section 7 – Interstate rules

All Australian States and Territories regulate the relationship between managed investment schemes (or mortgage financing or mortgage investment scheme) and law practices. However, there are different rules in place in each jurisdiction. The key restrictions are explained here. They are not as restrictive as those contained in s 258.

The Western Australian and Queensland legislation both stipulate that money provided in connection with financial services or investments is not trust money for the purposes of the relevant Acts. Then they outline that money held by a law practice in connection with a managed investment scheme or mortgage financing is also not regarded as trust money. However, such money involved in financial services or managed investment scheme is trust money where the money is held by the law practice in the ordinary course of legal practice and primarily in connection with the provision of legal services to or at the direction of the client and the investment is made in the ordinary course of legal practice and for the ancillary purpose of investment (s 206 of *Legal Profession Act 2008* (WA) and s 238 of *Legal Profession Act 2007* (Qld)).

The Australian Capital Territory and Northern Territory Acts adopt a different formulation, providing that a solicitor/legal practitioner is not prevented from carrying out any legal services in connection with a managed investment scheme operated by a responsible entity or having an interest in such a managed investment scheme or a responsible entity. However, if a client entrusts money to be invested in a managed investment scheme and the practitioner has an interest in the scheme, then the laws require the practitioner to give the client written notice of the interest the practitioner has in the scheme, the fact that the operation of the scheme does not form part of the law practice and confirmation there is no claim against the Fidelity Fund for a loss (s 377 of *Legal Profession Act 2006* (ACT) and s 448 of *Legal Profession Act* (NT)). Both Acts require practitioners who know of an associate who has contravened this section to write to the Law Society within 21 days (s 377(5) of *Legal Profession Act 2006* (ACT) and s 448(5) of *Legal Profession Act* (NT)). Further, the ACT Act states a contravention of this section can constitute professional misconduct (s 377(6) of *Legal Profession Act 2006* (ACT)).

In South Australia, a maximum penalty of $10,000 applies to the contravention of s 95BA of the *Legal Practitioners Act 1981* (SA) which states mortgage financing should not

be regarded as part of the law practice and a legal practitioner who engages in mortgage financing must inform each prospective lender and borrower, orally and in writing, that any loss will not be compensated by the Fidelity Fund or covered by professional indemnity insurance.

In Tasmania, a fine of up to 100 penalty units applies if a law practice contravenes s 413(1) of *Legal Profession Act 2007* (Tas). The section states a law practice must not engage in, administer or facilitate a mortgage investment scheme unless the mortgage investment scheme is conducted by a separate legal entity which does not form part of the law practice. A contravention of the section may result in professional misconduct and a fine of up to 50 penalty units if a practitioner does not notify the Board within 21 days of an associate who has contravened this section (ss 41(2) and (3) of *Legal Profession Act 2007* (Tas)).

Section 8 – Next steps

The Recommendations in Annexure D suggest various 'next steps' for the Council. These concern:

- the proposed amendments to s 258(1)(a)
- the proposed new Uniform Rules, and
- transition.

Following the Council's discussions on the inquiry's 30 September report, the inquiry provided an outline of the proposed recommendations and sought feedback from the professional bodies (Law Institute of Victoria, Law Society of New South Wales and Law Firms Australia) and several firms that had been part of the initial consultation. Some refinements to the proposals were made as a result of that further consultation. The inquiry notes that the proposed legislative amendments will be considered by the Standing Committee immediately but the proposed Uninform Rule changes will only be made upon approval by the Standing Committee after public consultation in accordance with the Uniform Law. We expect that the organisations consulted will wish to comment on both the policy positions adopted and on the proposed drafting as part of the formal consultation process for new Uniform Rules.

The second step is to contact, through the professional bodies, the law practices identified by the inquiry that may have to change what they or their related entities are doing after 1 July 2018 – this will include the small industry-supervised schemes mentioned in Section 4.1. This is to ensure that the practices understand the new rules and are prepared for transition.

The third is to prepare a guidance note for the profession generally, explaining the Council's interpretation of and enforcement approach to the restrictions imposed by s 258. The guidance should include practical examples of conduct that is or is not proscribed. The note should explain the interaction between s 258 and other relevant provisions of the Uniform Law and the Uniform Rules (including provisions relating to conflicts, other business activities and fidelity fund cover) and law practices' professional indemnity

insurance cover. The guidance note should be provided to the professional bodies for comment before it is published.

The fourth is to notify other interested bodies of the change to the law and the Council's approach to interpreting and applying it. Many of these bodies have been consulted as part of the inquiry – they include the peak bodies, the DLRAs, the fidelity funds and professional indemnity insurers. It will also be appropriate to inform interstate regulators of the changes coming into effect in the Uniform Law jurisdictions.

Annexure A – Terms of reference

That the Inquiry consider and report on:

1. The legal nature and scope of the prohibitions in s 258 of the Legal Profession Uniform Law, having particular regard to:
    a. The definition of 'managed investment scheme' (MIS) and its potential application to forms of financial intermediation currently provided by law practices and their related entities in Victoria and New South Wales
    b. The definition of 'related entity' for the purposes of s 258(1) and (4)
    c. The meaning of 'promote' or 'operate' in 258(1)(a)
    d. The meaning of 'interest' for the purposes of s 258(3)
    e. The meaning of 'in relation to' in s 258(3).
2. The extent to which law practices in Victoria and New South Wales are engaged in activities that will be prohibited by s 258(1), including:
    a. The number of Mortgage Businesses (as defined in ASIC Class Order 02/238) promoted or operated by law practices or related entities of law practices, the value of the investments held in them, and the investor profile
    b. The number of other registered and unregistered MIS promoted or operated by law practices or related entities of law practices, the value of the investments held in them, and the investor profile. [57]
3. The likely regulatory impacts if s 258(1) were repealed or not repealed, and the possible impacts in policy terms of either course, with particular regard to:
    a. The growth of multi-disciplinary law practices (incorporated and unincorporated)
    b. The impact on small and regional law firms of either course.
4. The likely regulatory impacts if s 258(3) were repealed or not repealed, and the possible impacts in policy terms of either course, with particular regard to:
    a. The likely nature and extent of interests held by associates of law practices in Victoria and New South Wales in MIS or responsible entities of MIS
    b. The policies and practices in place, including under Uniform Conduct Rule 12, to identify and prevent conflicts of interest where a law practice provides legal

[57] It may be necessary to estimate the extent of some of these activities.

services in relation to an MIS in circumstances where an associate of the law practice has an interest in the MIS or the responsible entity of the MIS.[58]

5. The likely regulatory impacts if s 258(4) were repealed or not repealed, and the possible impacts in policy terms of either course, with particular regard to the nature and extent of services provided by law practices to non-ADI lenders in respect of mortgages other than those described in s 258(4)(b).

6. The policy options available to the Council in:

    a. Defining 'related party' for law practices that are not ILPs for the purposes of s 258(1) and (4)

    b. Making a Rule for the purposes of s 258(1)(b) extending the prohibitions to other similar services and businesses

    c. Making a Rule for the purposes of s 258(3), and setting guidelines for approvals by designated legal regulatory authorities (DLRA), allowing a law practice to provide legal services in relation to an MIS where an associate of the law practice has an interest in the MIS or the responsible entity of the MIS

    d. Making a Rule for the purposes of s 258(4)(c) exempting other mortgages from the prohibition

    e. Making a Rule for the purposes of s 258(4)(a) specifying financial institutions other than ADIs.

7. Taking into account any recommendations made in respect of Terms of Reference 1 to 6 above, any steps, including communication and guidance, that the Council and the DLRA might take to help law practices, their clients and communities prepare for changes to the regulation of MIS and mortgage practices.

The Inquiry will consult with the Australian Securities and Investments Commission, the Council, the DLRA, the Law Institute of Victoria, the Law Society of New South Wales, the legal profession and other relevant stakeholders and report to the Council with recommendations by 30 September 2017.

27 June 2017

[58] In *Law Society of the Australian Capital Territory v Lardner* [1998] ACTSC 187 the law firm involved used the services of a separate entity with which it had a close working connection (operating from the same premises) without disclosing that relationship to the client.

Annexure B – Organisations consulted

Law Institute of Victoria (including LIV Managed Mortgage Section), Melbourne

Law Society of New South Wales, Sydney

Law Firms Australia, Sydney and Perth by teleconference

Australian Securities and Investments Commission, Sydney and Melbourne by teleconference

Legal Practitioners' Liability Committee, Melbourne

Victorian Legal Services Board and Commissioner, Melbourne

Various law firms and responsible entities involved in mortgage businesses in Victoria and New South Wales (listed on file)

The inquiry was advertised on the Council's website and open to submissions.

Annexure C – Section 258 of the Uniform Law

258 PROHIBITED SERVICES AND BUSINESS

(1) A law practice (or a related entity) must not--

(a) promote or operate a managed investment scheme; or

(b) provide a service or conduct a business of a kind specified in the Uniform Rules for the purposes of this section.

Civil penalty: 250 penalty units.

(2) Despite subsection (1), an associate of a law practice may promote or operate a managed investment scheme if, in the event of an insolvency or administration of the managed investment scheme, the associate is appointed as--

(a) an administrator, liquidator, receiver, receiver and manager, agent of a mortgagee or controller of the managed investment scheme in respect of the insolvency or administration; or

(b) a controller or external administrator of an entity acting in a similar capacity as a responsible entity where a managed investment scheme does not have a responsible entity in respect of an insolvency or administration.

(3) Except as permitted by or under the Uniform Rules, or as approved by the designated local regulatory authority, a law practice must not provide legal services in relation to a managed investment scheme if any associate of the law practice has an interest in the scheme or the responsible entity for the scheme.

Civil penalty: 250 penalty units.

(4) A law practice (or a related entity) must not, in its capacity as the legal representative of a lender or contributor, negotiate the making of or act in respect of a mortgage, other than--

(a) a mortgage under which the lender is a financial institution; or

(b) a mortgage under which the lender or contributors nominate the borrower, but only if the borrower is not a person introduced to the lender or contributors by the law practice who acts for the lender or contributors or by an associate or agent of the law practice, or a person engaged by the law practice for the purpose of introducing the borrower to the lender or contributors; or

(c) a mortgage, or a mortgage of a class, that the Uniform Rules specify as exempt from this prohibition.

Civil penalty: 250 penalty units.

(5) In this section—

"borrower" means a person who borrows, from a lender or contributor, money that is secured by a mortgage;

"contributor" means a person who lends, or proposes to lend, money that is secured by a contributory mortgage arranged by a law practice;

"contributory mortgage" means a mortgage to secure money lent by 2 or more contributors as tenants in common or joint tenants, whether or not the mortgagee is a person who holds the mortgage in trust for or on behalf of those contributors;

"financial institution" means--

(a) an ADI; or

(b) a corporation or other body, or a corporation or body of a class, specified in the Uniform Rules for the purpose of this definition;

"lender" means a person who lends, or proposes to lend, a borrower money that is secured by a mortgage.

(6) To the extent that this section applies to an incorporated legal practice, this section is declared to be a Corporations legislation displacement provision for the purposes of section 5G of the Corporations Act.

Annexure D – Summary of recommendations

1. **Should the Council recommend to Government that s 258(1)(a) be amended?**

   The Council should request the following amendments to s 258(1)(a):

   - Add 'except as permitted by or under the Uniform Rules'
   - Delete 'managed investment scheme' and replace with 'managed investment scheme in relation to which to which any of paragraphs 601ED(1)(a), (b) or (c) of the Corporations Act 2001 (Cth) is satisfied'
   - Add a carve-out for schemes connected with or related to the business structure, ownership or operation of the law practice itself.

2. **How should 'related entity' of an unincorporated legal practice be defined in the Uniform Rules for the purposes of s 258(1)(a) and s 258(4)?**

   The Uniform Rules should include a definition of 'related entity' for all law practices that mirrors the concept of a related body corporate in s 50 of the Corporations Act.

3. **What (if any) other services or businesses should be specified in the Uniform Rules for the purposes of s 258(1)(b)?**

   The Council should consult on introducing a Uniform Rule that extends the prohibition in s 258(1)(b) to arrangements that have similar functional characteristics to managed investment schemes, including debenture issuing mortgage finance companies, investment companies, superannuation funds and Corporate Collective Investment Vehicles (CCIVs).

4. **What legal services should be permitted by or under the Uniform Rules for the purposes of s 258(3)?**

   The Uniform Rules should include a Rule to the effect that, while a law practice is not prohibited by s 258 from providing legal services in relation to a managed investment scheme even if an associate of the law practice has an interest in the scheme or the operator of the scheme, the law practice must not provide the legal services to a person other than the operator if the law practice knows, or ought to know, that an associate has a substantial interest in the scheme or the operator.

5. **What corporations or other bodies, other than ADIs, should be included in the definition of 'financial institution' in the Uniform Rules for the purposes of s 258(4)(a)?**

   The Uniform Rules should include the following corporations and other bodies in the definition of 'financial institution' for the purposes of s 258:

   - a body that is a professional investor within the meaning of s 9 of the Corporations Act; and

- a body that is a credit licensee under s 35 of the *National Consumer Credit Protection Act 2009* (Cth) (Credit Act); and
- a body whose ordinary business includes the lending of money and whose gross assets exceed A$10 million; and
- a related body corporate, or body that controls or is controlled by, a body referred to above.

6. What mortgages should be specified as exempt by or under the Uniform Rules for the purposes of s 258(4)(c)?

The Uniform Rules should provide that the prohibition only applies where the lender or contributor has been introduced to the borrower by the law practice or an associate, agent or appointee of the law practice engaged in mortgage financing as defined in the Conduct Rules

7. What guidance should be given to the profession about the impact of s 258 prior to its commencement?

The Council should prepare and publish a guidance note explaining the restrictions that will be imposed by s 258, giving examples of conduct that is or is not proscribed. The note should explain the interaction between s 258 and other relevant provisions of the Uniform Law and the Uniform Rules including provisions relating to conflicts, other business activities and fidelity fund cover, and law practices' professional indemnity insurance cover. The guidance note should be provided to the professional bodies for comment before it is published.