

Illegal Managed Investment Schemes

The term “managed investment scheme” refers to forms of collective investments where investors pool money together to be managed by a third party. Investors then share in any profits during or at the end of the investment term. These schemes are regulated by ASIC under Chapter 5C of the Corporations Act 2001 (Act).

Australian Securities and Investments Commission (ASIC), the corporate watchdog, has illegal managed investment schemes on its radar.

ASIC’s role is to ensure that all managed investment schemes comply with the law so that people investing in them have access to the benefits, rights and protections that registered and compliant schemes provide.

The legislative protections include requirements to ensure that investors are provided with detailed, up to date and accurate information before making investment decisions and that they continue to be well informed about the operation of the investment.

Types of schemes operating outside the law

Schemes that allow a person to invest in property development, where that development is undertaken by another person, are likely to be managed investment schemes and must be registered with ASIC.

If the investment is through a debenture, different, but equally stringent, laws apply to this kind of fundraising. If the investment is through a promissory note, it is also possible that the scheme needs to be registered with ASIC.

Sixty percent of all illegal scheme matters referred to ASIC relate to property development and construction, including direct property investment and indirect property investment in the form of unit trusts and property syndicates. The recent interest in retirement village schemes and other apparently lucrative commercial ventures such as student accommodation villages has also created situations where people may seek funding through a managed investment scheme, often one requiring registration.

Mezzanine investing is the most common type of investment scheme offered, providing high-risk funding to property developers carrying out construction projects. Mezzanine investing involves putting money into projects and ventures financed outside the mainstream financial markets.

For example, a property developer trying to finance a new building on a vacant block of land may tap three sources of funds:

- First, the developer gets a loan from a bank or financial institution which will take out a first mortgage over the land. To avoid too much risk, the bank will only lend up to a certain amount, say 50%.
- Next comes the mezzanine investor, who may put in a substantial proportion of the money. Mezzanine literally means “middle” and here they are putting up the middle “slice” of the money. The mezzanine investor might get a second mortgage. However, in the event of default, the second mortgage is only of value if there’s enough money left over after the first mortgage gets paid out.
- The third and final level of funds is generally a smaller contribution by the property developer.

This source of funding is commonly used by property developers unable to gain access to traditional sources of funding such as banks. In many cases, it is unclear whether the scheme has a mortgage over the land comprising the construction project and the ranking of that mortgage – whether it is a first, second or even third mortgage that is being sold to the investor.

Sometimes, operators of these sorts of schemes say that they do not need to be registered or have a Product Disclosure Statement (PDS). ASIC knows of cases where operators have told investors that they fall outside of the Act. The Act is intended to provide a broad range of protection for investors and it is rare for a scheme not to be covered by the Act.

Penalties

Promoters or issuers who offer investments (known as “interests”) in unregistered managed investment schemes are breaking the law and risk facing serious consequences. For example, there are penalties for offering interests in such unregistered schemes and/or the giving of unlicensed financial advice of up to \$22,000.00, imprisonment for 5 years or both (ss911A and/or 1020A of the Act).

principal to be returned on completion of the project. Clearly, such rates of return are extremely improbable. People investing in such schemes are inevitably at high risk of losing their money. If a scheme does fail, investors are without the normal legal protections provided by the Act.

Risk to investors

Schemes are often sold as an opportunity for all kinds of investors to generate high returns for relatively small investment contributions. Investors are typically lured by the high rates of return offered, in some cases as much as 20-50% interest with the principal to be returned on completion of the project. Clearly, such rates of return are extremely improbable. People investing in such schemes are inevitably at high risk of losing their money. If a scheme does fail, investors are without the normal legal protections provided by the Act.

Complaints

A common feature of illegal investments is that investors are often reluctant to complain to ASIC about such activity. Investors don't want to confront the reality that an investment is either not going well or defunct. In many cases, wishful thinking leads people to continue to want to believe the "hard sell" about the investment opportunity.

Despite this reluctance, complaints continue to be made to ASIC from investors who have lost money in illegal managed investment schemes. A majority of complaints relate to property development schemes. Many of the people who have lost money in such illegal schemes sought no advice before investing.

Lawyers find it extraordinary that clients who have, in some instances, lost hundreds of thousands of dollars or more are then reluctant to take civil proceedings to recover losses.

A checklist for any illegal managed investment schemes

Service providers in the legal and taxation professions, as well as others working in building, real estate and property development, may well come across some of the illegal managed fund arrangements in the course of their day to day business activities.

Perform the five checks listed below to see whether a scheme is legal. If you are still not sure, or if you have been told that a managed investment scheme is not subject to the Corporations Act, you should make contact with Grope Hamilton Lawyers or ASIC.

For further information about illegal managed investment schemes or to make a complaint, please call ASIC's Infoline on 1300 300 630. Complaints can also be made via the ASIC website at www.asic.gov.au. One can also visit FIDO, ASIC's consumer website at www.fido.gov.au for information about investing and safety checks.

Is a managed investment scheme legal? The five safety checks:

1. Is the scheme operator a public company?

The operator of a registered managed investment scheme must set up a public company that is registered with ASIC on its public database. Check if the company exists by going to ASIC's website at www.asic.gov.au and searching the National Names Index, making sure it has Ltd after its name, not Pty Ltd.
<http://www.search.asic.gov.au/gns001.html>

2. Does the operator managing the investment hold an Australian Financial Services (AFS) licence from ASIC?

The public company that is responsible for the registered managed investment scheme must get a licence in the company's name to operate the scheme. Check if the company holds a licence by searching ASIC's register of Australian financial services licensees.
<http://www.search.asic.gov.au/fsr/flb.html>

3. Is the scheme on the Managed Investment Scheme database?

Check if the scheme is registered by searching ASIC's free national names index. Unregistered schemes may be illegal, and important legal protections may be lost. Remember that registered managed investment schemes can also be risky to the consumer – registration does not protect a scheme from market risk.
Free national names index

4. Visit FIDO, ASIC's website for consumers and investors, where you can check our list of illegal investments

This list documents schemes that have been investigated by ASIC and found to be illegal – but remember, just because a scheme isn't mentioned doesn't make it legal – the list doesn't document every illegal scheme in operation.
<http://www.fido.gov.au/fido/fido.nsf/byheadline/illegal%20investments%20list>

5. Ask the scheme operator for its Product Disclosure Statement (PDS)

Schemes must have a PDS. This document must give enough information about the scheme for you or your adviser to make an informed decision.