ASIC
Australian Securities & Investments Commission

REGULATORY GUIDE 147

Mutuality—Financial institutions

Part 5 Schedule 4 Corporations Law, Financial Sector (Transfers of Business) Act 1999, s63 Banking Act 1959

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From 5 July 2007, this document may be referred to as Regulatory Guide 147 (RG 147) or Policy Statement 147 (PS 147). Paragraphs in this document may be referred to by their regulatory guide number (e.g. RG 147.1) or their policy statement number (e.g. PS 147.1).

What this guide is about

RG 147.1 This guide describes how we will use our exemption powers when dealing with companies that are unlisted transferring financial institutions. In particular, it sets out how we will decide whether a company has a mutual structure.

RG 147.2 This guide applies to companies that ask us for an exemption under the special provisions of the Corporations Law (Law) that deal with transferring financial institutions (TFIs) (see Clause 30(1) and Clause 30(2) of Part 5 of Schedule 4 of the Law).

RG 147.3 Those provisions require us to decide whether a company has a mutual structure and whether a change to a company's constitution or an issue of shares might alter an existing mutual

structure, or allow it to be altered. To help us make this decision, we have developed the approach to mutuality set out in this policy.

RG 147.4 We will also apply this approach to mutuality if we are asked for a view about a company's mutual status where:

(a) Section 63 of the *Banking Act 1959* (Banking Act) applies. We are particularly interested in the application of this section to approved deposit taking institutions (ADI) incorporated after 30 June 1999

(b) APRA consults us about an application for a transfer of business, where one of the parties is a mutual organisation and the proposed transfer may result in a demutualisation.

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Our policy

RG 147.5 We will grant relief under Clause 30(1) if, at the time it makes an application, a company does not have a mutual structure.

RG 147.6 We will apply the approach to mutuality in this guide in the light of the history, structure and circumstances of the company to decide whether the applicant company has a mutual structure or not.

RG 147.7 If we receive an application from a company that has a mutual structure as described in this guide, we will not grant an exemption under Clause 30(1).

Underlying principles

RG 147.8 Our policy reflects the clear intent of the Law that exemptions under Clause 30(1) should only be available to companies that do not have mutual structures.

RG 147.9 For these purposes, a company does not have a mutual structure if it does not satisfy the tests for mutuality set out in this guide.

Explanations

RG 147.10 Part 5 of Schedule 4 of the Law applies when an unlisted company proposes modifications to its constitution that have or might have the effect of varying or cancelling the rights of members, or classes of members:

(a) to vote;

(b) to the reserves of the company;

(c) to the assets of the company on a winding up; or

(d) in a way that triggers the class rights provisions of Part 2F.2 of the Law.

RG 147.11 Part 5 also applies to an issue of shares where Part 2F.2 applies.

RG 147.12 Part 5 requires a company to make comprehensive disclosures to its members to ensure they are fully informed and can make a sound judgment about whether a demutualisation proposal is in their best interests.

RG 147.13 The disclosures Part 5 requires mutuals to make are intended to apply to changes that might result in a demutualisation. They therefore serve little or no purpose in companies that are already non-mutuals or are assessed as non-mutuals under this policy.

RG 147.14 If, by applying the approach to mutuality in this guide, we are satisfied that a company is not a mutual, we will exempt it completely from Part 5. This will be a continuing exemption.

RG 147.15 The ordinary provisions of the Law that deal with how companies are to be run will apply to companies that have this kind of exemption.

RG 147.16 If a company does not have a mutual structure, but is nonetheless an unlisted transferring institution of the kind referred to in Part 5, it needs to apply under Clause 30(1) for an exemption from the obligations in Part 5.

RG 147.17 A company that is a mutual is not eligible for relief under Clause 30(1). It may, however, qualify for relief from some or all of the provisions of Part 5 under Clause 30(2): see RG 147.19–RG 147.71.

RG 147.18 A company that is not a mutual but calls itself a mutual may breach s12DA of the *Australian Securities and Investments Commission Act 1989* (ASIC Act). Section 12DA prohibits a corporation from engaging in conduct in relation to financial services that is misleading or deceptive or is likely to mislead or deceive.

B Applications for exemption from mutuals

Our policy

RG 147.19 We will grant an exemption under Clause 30(2) if proposed changes to a company's constitution or a proposed share issue will not result in or allow a modification of the company's existing mutual structure. If a proposal affects existing mutuality arrangements but only in a very minor way, we will also grant an exemption under Clause 30(2).

RG 147.20 We will use the approach described in this guide to establish the impact of a proposal on the mutual structure of an applicant company.

RG 147.21 If we are concerned about the possible effect of a proposal on a company's mutual structure, we may impose conditions on an exemption (see Clause 30(5)).

RG 147.22 In some cases we may exempt a company from some but not all of the disclosure requirements, for example from the requirements for an expert's report in Clause 33.

RG 147.23 We will not exempt a company from all of the disclosure requirements in Part 5 unless there are exceptional circumstances.

RG 147.24 Where a proposal has the effect of threatening the company's mutual structure, we will not grant an exemption under Clause 30(2).

Underlying principles

RG 147.25 The obligations in Part 5 play an important role in ensuring members of mutuals are fully informed about decisions that may affect the mutual structure of their company. We will relieve companies from these obligations only when we can be confident that a proposed change will not have a significant impact on an existing mutual structure.

RG 147.26 We will examine each application to assess a proposal's impact on the applicant's mutual status by using the tests for mutuality

we have adopted (see RG 147.38–RG 147.71) and by looking at the particular circumstances of the applicant.

Explanations

RG 147.27 A company may trigger the disclosure obligations in Part 5 whether or not they are intending to demutualise. If a change to a mutual company's constitution or a share issue does not, and is not intended to, result in a demutualisation, the company can apply for an exemption under Clause 30(2). It will normally do so because it is unnecessary, inconvenient or expensive to comply with the enhanced disclosure requirements.

RG 147.28 If we receive an application for exemption under Clause 30(2), we must consider whether the modification of the applicant's constitution or the proposed share issue will result in a modification of the mutual structure of the company.

RG 147.29 We will use the approach to mutuality in this guide, in the light of the particular history and circumstances of the company, to establish the impact of a proposal on its mutual structure.

RG 147.30 The Law requires us also to consider whether the proposal will convert the company into a company run for the purpose of yielding a return to shareholders (Clause 30(4)).

RG 147.31 We will not grant an exemption if a proposal would risk altering the company's existing mutual structure in any significant way. This is because the Law intends the provisions in Part 5 to apply to such a demutualisation.

RG 147.32 There will be very few, if any, circumstances where we will give a complete or unconditional exemption from Part 5 under Clause 30(2). In most, if not all, circumstances the disclosure provisions of Part 5 will continue to apply. These provisions are, in effect, a codification of the common law of disclosure.

RG 147.33 Membership qualifications that significantly restrict the ability of members as a whole to participate in the governance of the company might lessen effective member control. They may therefore create risks for the company's mutual structure.

RG 147.34 Likewise, rules designed to protect mutuality that contain stringent provisions that have the effect of undermining members' ability to make decisions about the future of their company may themselves affect the mutual structure of a company. We may refuse an exemption if a change would produce that result.

RG 147.35 Part 5 is also triggered if an unlisted company issues shares with the effect of varying or cancelling rights so that Part 2F.2 applies.

RG 147.36 In circumstances where Part 2F.2 of the Law would apply, Clause 29(2) of Part 5 can apply to a share issue, even where the right to issue shares is contained in an existing constitution or has been made by a constitutional modification which is the subject of an ASIC exemption. The criteria for granting exemptions in this case will be the same as the criteria for exemptions applied for with regard to a constitutional modification under Clause 29(1).

RG 147.37 Any exemption granted under Clause 30(2) applies only to the specific proposal for which it is granted and does not apply as a general exemption for future proposals or as an exemption from Part 2F.2.

C Our approach to mutuality

Our policy

RG 147.38 We consider that an organisation has a mutual structure for the purposes of our policy only if the company and its members meet two tests:

(a) an economic relationship test; and

(b) a governance relationship test.

The economic relationship test

RG 147.39 To satisfy the economic relationship test, dealings between the company and its members and shareholders must meet all of the following criteria:

(a) If the company is wound up, the only people who are allowed to share in any undistributed surplus are current members (in their capacity as members by guarantee or as holders of a member share), a like institution or a charity.

(b) If there are investor shareholders, they must not participate in or otherwise accrue rights to surpluses in that capacity except by receiving dividends.

(c) The dividend that can be paid to holders of investor shares must:

(i) be limited by reference to an independent and objectively verifiable external benchmark or mechanism such as the bank bill swap rate or a stock exchange index, and be payable only out of that year's profits; or

(ii) not be more than a fixed percentage of the company's annual profit after tax in any year, and be payable only out of that year's profits. The fixed percentage cannot be more than 50%.

(d) Members must approve the way the company calculates dividends on investor shares at a general meeting before the company issues any investor shares. Directors must make sure that actual dividend payments are not more than the limits set by the general meeting.

The governance relationship test

RG 147.40 The governance relationship test is satisfied if the following criteria are met:

(a) Only members can participate in the governance of a mutual company. This does not prevent the appointment or election of non-member directors.

(b) Members must have the right to participate in the governance of the company on an equal footing with other members. This means:

(i) all fully qualified members each have one vote;

(ii) if there are membership and voting qualifications based on time periods and minimum balances these must be reasonable, for example having regard to customer member turnaround and the account balances of the majority of customer members; and

(iii) if the company has a form of representative governance that substitutes for a direct general meeting, each member has only one vote either in electing the representative or electing those who nominate the representative.

(c) A membership must only allow the person who holds it to have one vote. This does not prevent a person who holds a membership in more than one capacity from having one vote for each membership (for example, an individual membership and a joint membership with another person).

(d) No class of members (for example, investor shareholders in contrast to members) has any veto or special voting rights in relation to decisions made by the members generally, unless the Law requires it (see Part 2F.2 of the Law dealing with class rights).

Underlying principles

RG 147.41 We have issued this guide to help transferring financial institutions to understand how we will decide on those aspects of mutuality that the Law says are our responsibility.

RG 147.42 Our job as a regulator is to set the minimum criteria for deciding whether a company is a mutual for the purpose of the laws we administer. We therefore focus on the fundamentals of mutuality. We do this knowing that some companies and sectors have a view about what constitutes mutuality that is more restrictive than this

policy. We would not want to be seen to be taking a view on mutuality beyond that which the Law requires us to take. What might be desirable components of mutual structures beyond the minimum criteria is a matter about which individual companies or industry associations may form their own views.

RG 147.43 The approach we have taken is pragmatic and takes into account:

(a) the guidance provided in the Law;

(b) the need to ensure there is some real content to the concept of mutuality, and that mutual and non-mutual companies can be distinguished; and

(c) the way transferring financial institutions and transferring financial institution sectors have developed over time.

RG 147.44 We have adopted an approach based on two main tests, each containing a number of factors. This is because we do not think governance issues alone, or economic relationships alone, can define the concept of mutuality sufficiently. In our view, both tests need to apply for there to be a meaningful concept of mutuality.

Explanations

The need for a policy

RG 147.45 The Law provides some guidance about what amounts to a mutual structure. For example Clause 30(3) lists some factors we can take into account:

(a) the particular structure, circumstances and history of the company;

(b) whether each customer of the company is required to be a member of the company or each member (or joint membership) has only one vote;

(c) any other relevant matter in relation to the company or its members.

RG 147.46 Clause 30(4) says that, when we are deciding whether there is a change to a mutual structure, we must take into account whether the company as changed would have a purpose of yielding a return to shareholders.

RG 147.47 Our approach in this policy is guided by the relevant provisions of the Law, and as a general rule we will take the factors in

Clause 30(3) into account when assessing whether a company has a mutual structure. But in our view the statutory provisions are not meant to be exhaustive. We have therefore adopted the approach to mutuality in this policy to provide further guidance, and to help us make clear, consistent decisions on applications for exemptions that depend on the concept of mutuality.

Some particular issues

A company's purpose

RG 147.48 A company does not have a mutual structure if it converts to a company whose purpose is to yield a return to shareholders (Clause 30(4)). We take purpose in that context to mean dominant purpose, and we do not consider it fatal to a company's status as a mutual if it provides a return to shareholders. But that purpose must be limited, and must not be the dominant purpose of the company.

RG 147.49 ASIC will assess the dominant purpose of a company by analysing the relationship between the company and its members with reference to both the economic and the governance relationship tests.

Investment shares

RG 147.50 Traditionally, mutual companies have not issued shares designed to produce a return based on the profits of the company. Investor shares of that kind might have a substantial impact on the focus of the company, and on its status as a mutual. In practice, however, a number of companies that consider themselves mutual now have, or will seek to have, a mixture of mutual members and investor shareholders.

RG 147.51 We accept that a limited purpose of returns to shareholders can co-exist with a purpose of services to members. In our view, what is critical for a company's mutual status is its dominant purpose. We therefore read the reference to "purpose" in Clause 30(4) to mean dominant purpose. A company can provide a return to shareholders and remain a mutual, provided that the return to shareholders does not become the dominant purpose.

RG 147.52 We do not believe that issues of investor shares need to be limited to people who are also members of the mutual. This is because if investor shares have strictly limited economic rights (including no rights to accumulated surpluses) and no voting rights,

the holding of shares by non-members will not of itself be fatal to a company's mutual structure.

Customers as members

RG 147.53 One of the factors that we can take into account is whether customers must be members of the company (see Clause 30(3)(b)(i)). We think this is a relevant factor and will take it into account in cases that otherwise might be marginal. But we do not think it is fundamental to the concept of mutuality. We accept that a company can be a mutual even without this feature.

RG 147.54 In our view, this is consistent with the way the industry has come to treat this concept and our purposive approach to mutuality.

Distribution of surpluses

RG 147.55 Companies can also distribute surplus to members while still a going concern. If a company proposes to do this but wants to maintain its mutual structure, it must make sure that the proposal does not result in the company changing to one with a dominant purpose of yielding a return to shareholders. The risk of this happening is particularly acute if the proposal involves an issue of shares to investor shareholders.

The economic relationship test

RG 147.56 The members of a mutual should have first claim on the company's undistributed surplus if the company is wound up. Surpluses are usually built up as a result of business with the members over a number of years.

RG 147.57 Members who are also investor shareholders should not receive a larger portion of any distributed surplus than they are entitled to receive in their capacity as members. This applies equally to a surplus distributed while a company is a going concern.

RG 147.58 The limitation on how surpluses can be distributed on the winding up of a company (see RG 147.39(a)) does not preclude the repayment of a subscription to a member who purchases an investor share, or to a non member who had received an investor share as a result of the death, bankruptcy or mental incapacity of a member.

RG 147.59 We recognise the need for mutuals to raise capital to compete in the current financial environment, and also recognise the

need for capital injection to be rewarded by the payment of annual dividends.

RG 147.60 However, unlimited returns to investor shareholders in the form of dividends may in practice mean a change in a company's purpose, so that it becomes the purpose of yielding a return to shareholders. This means the company ceases to have a mutual structure (Clause 30(4)).

RG 147.61 For example, if there is no limit on the dividends that can be paid, directors may be pressured to exercise their discretion to declare higher dividends to make shares more valuable.

RG 147.62 We will pay particular regard to any proposal where the effect is:

(a) analogous to a dividend payment (such as the issue of redeemable preference shares where a percentage of the shares are redeemed each year); and

(b) a diversion of reserves or surplus which exceeds any diversion that would have been permitted under the dividend limitations in RG 147.39(c).

Governance relationship test

RG 147.63 Members must have real control over the way their company is governed. One member one vote is the most common and clearest way to achieve this in the mutual context. However, in our view some systems of proportional representation (such as collegiate voting) are consistent with mutuality, or at least need not threaten the company's mutual structure.

RG 147.64 Likewise, reasonable membership qualifications or voting restrictions for some members are often seen as necessary for fair member governance of the mutual. We accept that a company does not cease to be a mutual merely because it has membership or voting qualifications. But membership and voting qualifications based on time periods and minimum account balances must be reasonable in the circumstances of the particular company.

RG 147.65 Minimum account balance requirements should not be more than a reasonable dollar amount taking into account the balances of the majority of customer members. Qualification periods should not be unreasonably long and should reflect the rate at which members leave and new members join.

RG 147.66 Minors excluded from voting merely because of their age should not be treated in the same way as members who are disqualified for failure to meet membership qualifications. In particular, minors should participate equally with other members in any distribution of surpluses.

RG 147.67 Mutuals should exercise caution in setting membership qualifications to make sure that member qualifications do not effectively:

(a) advantage a minority (we would expect no more than a small percentage of members, such as 10%, to be excluded as a result of membership or voting qualifications); or

(b) frustrate effective member control (high-threshold membership qualifications may effectively result in a large percentage of members being disenfranchised and affect member control of the company thereby threatening the company's mutual structure); or

(c) trigger the class rights provisions of the Law.

RG 147.68 Members entitled to vote because they hold a member share or have given a guarantee must still have only one vote, even if they also hold investor shares.

RG 147.69 There will be members who are members in their own right, but who also hold a joint membership, or are a representative of or proxy holder for another member. In these circumstances, the member can vote their own membership, and also be the means by which the joint membership votes or the other members vote. In our view, this would not mean that the person effectively has more than one vote.

D Other applications of our approach to mutuality

RG 147.70 We will also apply the approach in this guidewhen we exercise the powers the Treasurer has delegated to us under s63 of the Banking Act. Section 63, including the demutualisation guidelines implemented under s63(8), has a similar effect to Part 5 and our approach to both demutualisation regimes is, as far as possible, the same.

RG 147.71 A mutual company may propose a transfer of business to a company, which does not have a mutual structure as described in this policy. In that case, we will suggest to APRA that approval of the transfer of business should be conditional upon the transferring company complying with Part 5, as if Part 5 applied.

Key terms

RG 147.72 In this guide:

"APRA" means the Australian Prudential Regulation Authority

"ASIC" means the Australian Securities and Investments Commission

"Banking Act" means the *Banking Act 1959*

"company" means a financial institution as defined below

"demutualisation provisions" or "demutualisation regime" means Part 5 of Schedule 4 of the Law, specifically Clauses 29 and 3133, and Section 63 of the Banking Act and related guidelines.

"financial institution" means a company that is:

(a) for the purposes of Part 5, an unlisted transferring financial institution (registered under Clause 3 of Schedule 4 of the Law); or

(b) for the purposes of s63 of the Banking Act, an ADI incorporated after 30 June 1999.

"investor share" is a share in a mutual company that provides a dividend return to the investor shareholder.

"investor shareholder" is a person who holds an investor share.

"Law" means the Corporations Law.

"member" means a member for mutual purposes (but not necessarily a "member" for all purposes of the Law), ie a person who is admitted to membership under the company constitution (either by member share or guarantee) to receive benefits or services, and who has met any other membership qualifications, if relevant.

"Part 5" means Part 5 of Schedule 4 to the Corporations Law.

"surplus" means that part of the income of the company that is available for reinvestment into the company or for payment by way of limited dividend to investor shareholders (after operating expenses have been deducted).

"transferring financial institution" has the meaning given to it in Clause 1 of Schedule 4 to the Corporations Law.

"undistributed surplus" means that part of the income of the company that has been retained in reserve to provide for the continued operation of the company in providing services to members and meeting operational expenses. It does not mean subscription payments.

Related information

RG 147.73

Headnotes

Mutuality; financial institutions; Part 5 Schedule 4 exemptions

Legislation

Part 5 of Schedule 4 to the Corporations Law
Financial Sector (Transfers of Business) Act 1999
Section 63 *Banking Act 1959*

Consultation papers

CP 10 *Mutuality* (June 2000)

Media releases

[MR 99/458], [MR 00/394]