
TREASURY LAWS AMENDMENT (MEASURES FOR A LATER SITTING) BILL
2018: MUTUAL ENTITIES (TRANCHE 2)

EXPOSURE DRAFT EXPLANATORY MATERIALS

Table of contents

| | |
|--|---|
| Glossary..... | 1 |
| Chapter 1 Reforms to the mutual sector..... | 3 |

Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

| <i>Abbreviation</i> | <i>Definition</i> |
|----------------------------|---|
| ACNC Act | <i>Australian Charities and Not-for-profits Commission Act 2012</i> |
| Corporations Act | <i>Corporations Act 2001</i> |
| ITAA 36 | <i>Income Tax Assessment Act 1936</i> |
| MCI | <i>Mutual Capital Instruments</i> |
| Hammond Report | <i>Report on Reforms for Cooperatives, Mutuals and Member-owned Firms</i> |

Chapter 1

Reforms to the mutual sector

Outline of chapter

1.1 This Chapter provides an overview of amendments in Schedule 1 to the Bill to provide for mutual entities registered under the *Corporations Act 2001* (Corporations Act) to issue mutual capital instruments (MCIs) without risking their mutual structure or status.

1.2 All references in this Chapter are to the Corporations Act unless stated otherwise.

Context of amendments

1.3 Cooperative and mutual entities operate in almost every sector of the Australian economy, including agriculture, banking and finance, housing, insurance and retail.

1.4 On 2 March 2015, the Senate Economics References Committee (Committee) was asked to review and report on the role, importance and the operations of these firms in the Australian economy. The Committee tabled their report on 17 March 2016.

1.5 On 24 March 2017, the then Treasurer appointed Mr Greg Hammond to conduct further consultation on the recommendations of the Senate Report and assist in developing a Government Response. Mr Hammond provided his *Report on Reforms for Cooperatives, Mutuals and Member-owned Firms* (Hammond Report) on 31 July 2017.

1.6 On 8 November 2017, the Government tabled its response to the Senate Report and accepted all eleven recommendations in the Hammond Report. The recommendations in the Hammond Report are aimed at improving access to capital, removing uncertainties currently faced by the mutual sector, and reducing barriers to enable cooperatives and mutuals to invest, innovate, grow and compete.

1.7 Historically, cooperatives and mutuals have generally only raised capital through retained earnings rather than issuing securities to investors. This has significantly constrained their flexibility and speed of growth. Allowing mutuals to raise equity capital will remove a significant barrier to investment, innovation, growth and competition in the sector.

1.8 The amendments in Schedule 1 of the Bill give effect to recommendation 8 of the Hammond Report to provide for mutual entities

registered under the Corporations Act to issue MCIs without risking their mutual structure or status. The ability to issue MCIs will provide mutuals with access to a broader range of capital raising and investment options.

Summary of new law

1.9 There are two key components to the amendments in Schedule 1.

1.10 The first is to provide for MCIs as a new bespoke capital instrument for mutual entities. MCIs can be issued by eligible mutual entities that are companies limited by shares, companies limited by guarantee and companies limited by shares and guarantee.

1.11 The second component of the amendments is to provide a standard process to allow eligible mutual entities to amend their constitutions to allow them to take advantage of these reforms to issue MCIs.

Comparison of key features of new law and current law

| <i>New law</i> | <i>Current law</i> |
|--|--|
| MCIs are a new type of bespoke share for the mutual sector. | No equivalent. |
| Mutual entities that are companies limited by shares, companies limited by guarantee and companies limited by shares and guarantee can raise equity capital by issuing MCIs. | Mutual entities that are companies limited by shares and companies limited by shares and guarantee can raise capital by issuing shares but mutual entities that are companies limited by guarantee cannot. |
| For a three year period, eligible mutual can amend their constitutions by following a standardised process to allow mutual entities to take advantage of these reforms. | A mutual entity must follow the process for constitutional amendment as provided for in its constitution. |

Detailed explanation of new law

MCIs: A bespoke capital instrument for the mutual sector

1.12 The amendments in Part 1 of Schedule 1 of the Bill provide for eligible mutual entities (as defined in the Treasury Laws Amendment

(mutual entities) Bill 2018) to issue MCIs, a bespoke share that has been created for the mutual sector.

1.13 The ability to issue MCIs will provide mutual entities with access to a broader range of capital raising and investment options without risking their mutual structure or status.

Who can issue MCIs?

1.14 Mutual entities that are registered as companies limited by shares or companies limited by shares and guarantee already have the power to issue shares and therefore have the power to issue MCIs.

1.15 However section 124 of the Corporations Act operates to prevent a mutual entity that is a company limited by guarantee from issuing shares. This restriction is amended to allow eligible mutual entities that are companies limited by guarantee to issue MCIs. [*Schedule 1, Part 2, item 4, subsection 124(4)*].

Requirements to be able to issue MCIs

1.16 Mutual entities that are registered as one of these three types of companies will be eligible to issue MCIs if they are:

- public companies;
- do not have voting shares (other than MCIs) quoted on a prescribed financial market; and
- are not a registered entity within the meaning of the *Australian Charities and Not-for-profits Commission Act 2012* (ACNC Act).

[*Schedule 1, Part 1, item 2, subsection 167AD(1)*]

1.17 In addition, to be able to issue an MCI, an eligible mutual entity will also need to provide in its constitution:

- that it intends to be an MCI mutual entity for the purposes of the Corporations Act;
- that all MCIs it issues must be fully paid;
- that dividends in respect of MCIs are non-cumulative;
- the rights attached to MCIs with respect to participation in surplus assets and profits; and
- that debts owed to a holder of an MCI by way of a divided (as per section 254V of the Corporations Act) are to rank ahead of all other debts owed to members in a winding up but rank below all other debts.

[*Schedule 1, Part 1, item 2, subsection 167AD(1); Schedule 1, Part 1, item 2, section 167AF; Schedule 1, Part 1, item 2, section 167AG*]

Features of an MCI

1.18 The amendments in Schedule 1 of the Bill provide that the rights attaching to an MCI can only be varied by either:

- a special resolution of all members holding the same class of MCIs; or
- obtaining written consent of 75% of the holders of the class of MCI.

[Schedule 1, Part 1, item 2, subsection 167AD(1); Schedule 1, Part 1, item 2, section 167AE]

1.19 If a mutual entity ceases to meet the requirements for issuing MCIs outlined above or an MCI ceases to have any of the features outlined above, the share will cease to be an MCI. It will continue to exist and operate as a share but will no longer meet the requirements for being an MCI. *[Schedule 1, Part 1, item 2, subsection 167AD(2)]*

1.20 To avoid doubt, a mutual entity that issues an MCI is not required to treat the holders of an MCI in the same way that it treats its members who do not hold MCIs. *[Schedule 1, Part 1, item 2, subsection 167AD(3)]*

Example 1.1

Unity One is a mutual entity that provides its members with insurance products. Jennifer, Linley and Daniel have insurance products from and are members of Unity One.

Unity One has MCIs on issue and some of the MCIs are owned by Michael, Nayanisha and Greg.

Unity One decides to reward its members by providing them with exclusive pre-sale access to tickets to the hit band ‘Peter and the Mutuos’.

Jennifer, Linley and Daniel receive the pre-sale access as they are members of Unity One. Michael, Nayanisha and Greg are not given access as their membership to Unity One is only through their ownership of its MCIs.

Michael finds out about the pre-sale access through his good friends Jennifer and Linley and complains to Unity One.

Unity One explains to Michael that the pre-sale access is only for its members who have insurance policies and that they are not required to treat an MCI holder like Michael in the say way that they treat non-MCI members.

1.21 As MCIs are limited to one vote per MCI holder regardless of the number of MCIs the holder owns, MCIs will not be taken into account when determining whether an entity is a subsidiary of another entity or an entity has control over another entity for the purposes of the Corporations Act [*Schedule 1, Part 2, item 3, subsection 48(6); Schedule 1, Part 2, item 9, section 910A (paragraph (b) of the definition of control)*]

Consequences of issuing an MCI

1.22 Once an eligible mutual entity issues an MCI it will become an MCI mutual entity. [*Schedule 1, Part 1, item 2, section 167AC*]

1.23 MCI mutual entities that are companies limited by guarantee will be able to pay dividends in respect of MCIs. [*Schedule 1, Part 2, item 6, subsection 254WA(1)*]

1.24 MCI mutual entities must not pay dividends in respect of an MCI unless the payment of the dividend is fair and reasonable to its members as a whole (as opposed to only its shareholders). [*Schedule 1, Part 2, item 6, subsection 254WA(2)*]

1.25 Once a mutual entity becomes an MCI mutual entity, resolutions that would result in the entity ceasing to be an MCI mutual entity will not have any effect unless the resolution provides for all MCIs on issue to be cancelled. [*Schedule 1, Part 1, item 2, section 167AH*]

1.26 This will effectively ensure that a mutual entity that issues MCIs is not able to demutualise without first dealing with any MCIs on issue. This could be done by first extinguishing the MCIs on issue or by addressing the MCIs as part of the relevant resolution. Cancelling the MCIs could involve buying them back to extinguish them or providing for them to be cancelled prior to the demutualisation with MCI holders to be given replacement shares following the demutualisation.

1.27 The restriction does not prevent a court from making an order under section 233 of the Corporations Act that would result in the demutualisation of a mutual entity or a mutual entity ceasing to be an MCI mutual entity. It is however anticipated that a court would consider the existence of any MCIs and make appropriate consequential orders to address them.

Modernisation without corporatisation

1.28 The mutual sector is very diverse with mutual entities operating in almost every sector of the Australian economy. Mutual entities have historically been very protective of their mutuality and have included strict demutualisation provisions in their constitutions. These provisions were based on historic legislative settings and may prevent some mutual entities from making use of the reforms to be delivered through the amendments in this Bill.

1.29 As such, to facilitate the use of these reforms by all eligible mutual entities, the amendments provide for a special standardised procedure to allow mutual entities to make the necessary amendments to their constitutions to allow them to issue MCIs. These provisions are included in Division 3 of the new ‘Part 2B.8 – Mutual capital instruments (MCIs)’ which has been created at the end of Chapter 2B of the Corporations Act. The special procedure is available to mutual entities that:

- are public companies;
- do not have voting shares quoted on a prescribed financial market; and
- are not a registered entity within the meaning of the ACNC Act.

[Schedule 1, Part 1, item 2, section 167AI]

1.30 The special procedure will allow an eligible mutual entity to amend its constitution to:

- include a statement that it intends to be an MCI mutual entity;
- provide for it to issue MCIs;
- specify the rights and obligations attaching to any MCIs it issues; and
- make other incidental or ancillary changes that are required.

[Schedule 1, Part 1, item 2, subsection 167AJ(1)]

1.31 The special procedure cannot result in a change to a mutual entity’s constitution that would result in it ceasing to be a mutual entity.

[Schedule 1, Part 1, item 2, subsection 167AJ(2)]

1.32 A mutual entity relying on the special procedure must provide notice of the proposed resolutions in accordance with the existing requirements provided for in paragraph 249L(1)(c) of the Corporations Act and the resolution cannot deal with any other matters. *[Schedule 1, Part 1, item 2, subsection 167AJ(1); Schedule 1, Part 1, item 2, subsection 167AK(1)]*

1.33 The special procedure provides for mutual entities to make the changes outlined above if the resolution is passed by 75 per cent of the votes cast by members who are present (including via proxy) at the meeting and entitled to vote on the resolution. *[Schedule 1, Part 1, item 2, subsection 167AK(2)]*

1.34 The special procedure applies regardless of anything else provided for in a mutual entity’s constitution in relation to process or quorum requirements. *[Schedule 1, Part 1, item 2, subsections 167AK(2) and (3)]*

1.35 The special procedure is only available for a fixed period of 36 months from the time this Bill receives Royal Assent and a mutual entity can only try to make use of the process a total of three times. The ability to use the process up to three times has been included to provide for circumstances where a mutual entity comes close to but does not get enough votes to make the required constitutional changes. *[Schedule 1, Part 1, item 2, subsection 167AK(1)]*

Consequential amendments

1.1 The definitions in section 9 of the Corporations Act are updated to cross reference the new definitions of MCI, MCI amendment resolution and MCI mutual entity. *[Schedule 1, Part 1, item 1, section 9]*

1.2 The amendments relating to MCIs have been included in a new 'Part 2B.8 – Mutual capital instruments (MCIs)' which has been created at the end of Chapter 2B of the Corporations Act. *[Schedule 1, Part 1, item 2, Part 2B – Mutual capital instruments (MCIs)]*

1.3 A simplified outline of new Part 2B.8 is provided for in new section 167AB. *[Schedule 1, Part 1, item 2, section 167AB]*

1.36 Provisions relating to class rights in Part 2F.2 currently operate differently depending on whether a company has a share capital or not. A MCI mutual entity (a mutual entity that has MCIs on issues) would have a share capital and therefore Part 2F.2 would only apply in relation to the entity's MCI holders. To preserve the Part's application to the mutual entity's other non-shareholder members, a consequential amendment is included to provide that the provisions in the Part should:

- apply to a person who holds an MCI as if the entity is a company with share capital; and
- apply to a person who is member of the entity otherwise than as a MCI holder as if the entity is a company without a share capital.

[Schedule 1, Part 1, item 1, section 9; Schedule 1, Part 2, item 5, section 246H]

1.37 Provisions relating to share capital reductions and share buy backs in Part 2J.1 of the Corporations Act refer only to shareholders. However as MCI mutual entities that are companies limited by guarantee can also issue MCIs the references to shareholder in the Part are taken to also include other non-shareholder mutual members. The change only applies once a mutual entity has an MCI on issue and therefore becomes an MCI mutual entity. The change ensures that all mutual members of MCI mutual entities that are companies limited by guarantee will be able to vote on changes affecting share capital reductions and share buy backs. *[Schedule 1, Part 2, item 7, subsection 258G(1)]*

1.38 Division 1 of Part 2J.1 of the Corporations Act provides for equal and selective reductions of share capital. The amendments provide that reductions of share capital that relate to MCI mutual entities are taken to be selective reductions because a reduction can only be an equal reduction if it relates to ordinary shares. [*Schedule 1, Part 2, item 7, subsection 258G(2)*]

1.39 Division 2 of Part 2J.1 of the Corporations Act provides for equal and selective share buyback schemes. The amendments provide that buybacks that relate to MCI mutual entities are not taken to be an equal access scheme as equal access schemes can only relate to ordinary shares. [*Schedule 1, Part 2, item 7, subsection 258G(3)*]

1.40 To ensure the 10/12 limit for share buybacks works in relation to MCI mutual entities, subsections 257B(4) and (5) will have effect in relation to an MCI as if each MCI were a voting share with one vote attached to it. [*Schedule 1, Part 2, item 7, subsection 258G(3)*]

1.41 For MCI mutual entities, references to a shareholder in Part 2J.3 are taken to include the mutual entity's non-shareholder members. [*Schedule 1, Part 2, item 8, subsection 260DA(1)*]

1.42 The existing requirements for entities to get shareholder approval for share capital reductions, share buybacks and the provision of financial assistance relating to the acquisition of the entity's shares are modified for MCI mutual entities so that approval is required from all members of the entity. [*Schedule 1, Part 2, item 7, subsection 258G(2); Schedule 1, Part 2, item 7, subsection 258G(3); Schedule 1, Part 2, item 8, subsection 260DA(1)*]

1.43 To avoid doubt, the modification to the operation of Parts 2J.1 and 2J.3 do not have the effect of requiring an MCI mutual entity to treat a non-shareholder member's membership as a share. [*Schedule 1, Part 2, item 7, subsection 258G(4); Schedule 1, Part 2, item 8, subsection 260DA(2)*]

1.44 The *Financial Sector (Shareholdings) Act 1998* and the *Insurance Acquisitions and Takeovers Act 1991* are amended to ensure that an MCI mutual entity's non-shareholder mutual member's voting rights are taken into account in assessing voting power for the purposes of the two acts. [*Schedule 1, Part 3, item 10, Subsection 9(4) of Schedule 1 to the Financial Sector (Shareholdings) Act 1998; Schedule 1, Part 3, item 16, subsection 13(4) of the Insurance Acquisitions and Takeovers Act 1991*]

1.45 The *Income Tax Assessment Act 1936* (ITAA 36) is amended to clarify that having MCIs on issue, the payment of dividends in respect of MCIs and having members who are member by virtue of holding an MCI should be disregarded in considering whether an entity is a mutual or not. [*Schedule 1, Part 3, item 11, subsection 121AB(1) of the ITAA 1936; Schedule 1, Part 3, item 12, subsection 121AC(1) of the ITAA 1936; Schedule 1, Part 3, item 13, subsection 121AC(2) of the ITAA 1936; Schedule 1, Part 3, item 14, subsection 326-10(1A) to Schedule 2H of the ITAA 1936*]

1.46 The *Income Tax Assessment Act 1997* is amended to ensure that the issuing of MCIs does not demutualise an entity for the purposes of the act. [*Schedule 1, Part 3, item 15, subsection 995-1(1) of the Income Tax Assessment Act 1997*]

Application and transitional provisions

1.47 The amendments in Schedule 1 of the Bill take effect from the day after Royal Assent.