KING&WOOD MALLESONS

Level 61
Governor Phillip Tower
1 Farrer Place
Sydney NSW 2000
Australia

T +61 2 9296 2000
F +61 2 9296 3999

www.kwm.com

21 December 2018

To Laura Llewellyn
Senior Adviser
Financial System Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email: mutualreform@treasury.gov.au

Dear Laura

***Treasury Laws Amendment (Measures for a later sitting) Bill 2018: Mutual entities (tranche 2)* — submission to Treasury by King & Wood Mallesons**

We refer to the exposure draft of the *Treasury Laws Amendment (Measures for a later sitting) Bill 2018: Mutual entities (tranche 2)* (**Tranche 2 Bill**) and explanatory material which was released by Treasury for consultation on 26 November 2018. We also refer to our submission to Treasury's consultation on the *Treasury Laws Amendment (Mutual entities) Bill 2018* (**First Mutuals Bill**) dated 31 October 2018.

We understand the challenges the mutual sector has experienced in raising capital and we are pleased to see the amendments proposed to be made to the *Corporations Act 2001* (Cth) (**Corporations Act**) by the Tranche 2 Bill. We note that those amendments are intended to implement Recommendation 8 of the inquiry into *Reforms for Cooperatives, Mutuals and Member-owned Firms* (conducted by Greg Hammond OAM, a former partner of our firm) (**Hammond Report**) — ie, that "*The Corporations Act be amended to expressly permit mutuals registered under the Act to issue capital instruments without risking their mutual structure or status*".

Our submission relates to the following matters, on which we have made some comments and raised some queries in sections 1 to 7 below:

- voting rights;
- status and ranking of MCIs;
- return of capital on a winding-up;
- cancellation of MCIs;
- disclosure regime
- tax issues; and
- ASIC exemption power.

KING&WOOD MALLESONS

1 Voting rights

Comments / observations

We note that the Tranche 2 Bill does not set out any requirements with respect to the voting rights (if any) of MCI holders, although it appears as though the intention is for MCI holders to have no more than one vote regardless of the number of MCIs the holder owns (see paragraph 1.21 of the draft explanatory statement).

Assuming it is the case that MCI holders are to have no more than one vote, we raised some issues in our submission on the First Mutuals Bill in relation to the different capacities in which members of mutual entities vote. For example, some mutual entity constitutions permit a person to be a member in his or her individual capacity and also in a separate capacity (eg as trustee for an unincorporated association) and still be permitted to vote each membership interest.

Queries

Would it be possible to clarify that a person who holds an MCI in more than one capacity may have a vote for each capacity?

Suppose a person holds an MCI and is also a member of the mutual in another way: is it intended that it has one vote as holder of an MCI and one as holder of its other interest, or does it have only one vote for all its interests?

We appreciate these points may be clarified via amendments to the First Mutuals Bill.

2 Status and ranking of MCIs

Comments / observations

Section 167AF of the Tranche 2 Bill provides that, as regards dividends owed in a winding-up of a mutual entity, the claim of an MCI holder would rank ahead of the claims of members but behind all other claims (for example, the claim of an MCI holder would rank behind other "subordinated claims" in section 563A of the Corporations Act).

However, there may be issues in practice, as outlined in our queries below. The expression "debts owing to members in their capacity as such" has been the subject of some case law, as it has not always proved easy to apply.

We also see potential for inconsistency with Attachment K to APS 111. We expect that mutual ADIs will want their MCIs to meet the requirements of Attachment K to APS 111 in relation to "mutual equity interests" (**MEIs**). See, for example, paragraph 1(b) of Attachment K, which provides that MEIs must rank after all other claims including the claim of a member in relation to the subscription price for the member share. Further, under paragraph 1(a) of Attachment K to APS 111, claims of holders of MEIs must be subordinated to all claims except for the claim of a member to residual assets.

Queries

We query whether it is necessary to provide for the ranking of claims of an MCI holder by legislative amendment (as set out in proposed section 167AF) and whether, as a matter of policy, claims for declared dividends in a winding-up must rank ahead of debts owing to a member in that capacity. For example, it may be possible to provide that such claim ranks ahead of those debts but could rank

equally, or lower, if the entity so decides. In the case of a prudentially regulated entity, this may be necessary to achieve compliance with Attachment K of APS 111.

Further, given the proposed inclusion of section 167AF, it may be helpful to clarify:

- what debts would typically be owing to members of a mutual entity in their capacity as such (for example, if this is intended to refer to the right to be repaid capital on a withdrawable share);
- where the right of an MCI holder to a return of capital ranks on a winding-up and if it is intended that the mutual entity is free to specify that;
- whether an MCI is intended, by virtue of the preference afforded in section 167AF, to be a "preference share" within the meaning of section 254A(2) of the Corporations Act and, if so, whether a mutual entity must comply with section 254A(2) when issuing MCIs. We assume that this is not the intention (but rather an MCI is a new bespoke form of capital), but we think it would be helpful for the legislation or explanatory statement to make it clear that:
  - an MCI should not be regarded as a preference share for any purpose under the Corporations Act (given the potential application of various provisions in Parts 2F.2 (Class Rights), Part 2H (Shares) and 2J.1 (Share capital reductions and buy-backs)); and
  - an MCI is intended to be capable of qualifying as Common Equity Tier 1 capital;
- how section 167AF would interact with, for example, Attachment K to APS 111, in respect of prudentially regulated mutual entities, including whether the requirements of Attachment K are intended to apply in addition to the MCI requirements. We think there is potential for inconsistency between section 167AF and Attachment K to APS 111; and
- whether, in the case of a mutual ADI, an MEI is intended to be a "species" of MCI (we assume that is the case but it would be helpful if this were made clear).

3 Return of capital on a winding-up

Comments / observations

The proposed provisions are silent on the rights of an MCI holder to a return of capital on a winding-up.

In relation to mutual ADIs, we note that paragraph 1(b) of Attachment K to APS 111 provides for holders of MEIs to be paid an amount out of surplus assets equal to the capital invested (such claim ranks behind all claims including claims by members for the subscription amounts paid for their member shares).

Queries

We query whether section 167AG of the Tranche 2 Bill should require that the mutual entity's constitution set out the rights of an MCI holder in relation to return of capital. See, by way of comparison, section 254A(2) of the Corporations Act (which does require constitutions to set out such rights in relation to preference shares).

Further, it may be helpful to clarify:

- whether section 167AG(c) of the Tranche 2 Bill, regarding surplus assets and profits, is intended to relate to return of capital; and

- the meaning of “surplus assets” in this context – in particular, whether this refers to the surplus assets after payment of creditors or the surplus assets after payment of creditors and shareholders having a fixed right to return of capital.

We note, by way of comparison, that section 254A(2)(b) of the Corporations Act, regarding preference shares, deals separately with surplus assets and profits.

4 Cancellation of MCIs

Comments / observations

We note that section 167AH of the Tranche 2 Bill provides for the cancellation of MCIs before an MCI mutual entity can demutualise.

Presumably, the cancellation of MCIs would require the approval of the holders (this is contemplated in section 167AE of the Tranche 2 Bill). We assume that holders of MCIs would only approve a cancellation if there is a prior return of capital approved by the members (or some other compensation). Further, we note that section 258G of the Tranche 2 Bill will make Part 2J.1 of the Corporations Act, regarding share capital reductions and share buy-backs, applicable to MCI mutual entities.

Query

We query whether section 167AH of the Tranche 2 Bill should refer to the requirement for the class of holders to approve the cancellation.

5 Disclosure regime

Comments / observations

There are several references in the Tranche 2 Bill to MCIs being “a share in a mutual entity”.

The Hammond Report noted a number of key matters to consider in drafting the amendments to allow for the issuance of MCIs by mutual entities. Those matters included “confirming mutual capital instruments are securities and subject to the Corporations Act fundraising provisions”.

Query

Although the new provisions imply that MCIs are shares (which would therefore make the disclosure regime in Chapter 6D of the Corporations Act applicable to them, as well as other parts of the Corporations Act, such as those relating to licensing and market conduct), it may be helpful to clarify this expressly in the text of the Bill or in the explanatory memorandum to it.

KING&WOOD MALLESONS

6 Tax issues

Comments / observations

It would be helpful if the amendments to the Income Tax Assessment Act could clarify that dividends on MCIs can be franked.

In addition, as many mutual entities have accumulated franking credits, it would also be useful if the Income Tax Assessment Act could clarify whether or not only current year or current year *and* historical franking credits can be utilised (with the preference being for the latter).

There are also some uncertainties associated with whether the withholding tax rules and double tax treaties to which Australia is party will treat MCIs the same as ordinary shares (this is relevant to the extent MCIs may in the future be quoted securities and therefore able to be held by foreign residents).

Query

To the extent it is not feasible to address all of these uncertainties before the Tranche 2 Bill is put before parliament, consideration should be given to including a statement in the explanatory memorandum that for the purposes of all other Commonwealth legislation not addressed by the Tranche 2 Bill, the intent is that MCIs be treated, as far as practicable, in the same way as ordinary shares.

7 ASIC exemption power

Comments / observations

We submit that the amendments proposed by the Tranche 2 Bill should include a broad exemption and modification power, administered by ASIC, which should apply to the new provisions imported by the amendments (ie Part 2B.8), as well as to the existing parts of the Corporations Act which will be amended to apply to MCI mutual entities (ie Part 2F.2, Part 2H.5, Part 2J.1, Part 2J.3).

Despite the commonalities amongst mutuals, many mutuals have bespoke governance arrangements which are unique to their history and customer offering. Accordingly, it is possible that the proposed amendments may not contemplate the specific circumstances of each mutual entity which seeks to issue MCIs. An exemption power would allow for the administration of the new regime in a manner consistent with the policy of the provisions on a case-by-case basis, similar to other areas of the corporations law.

Under the Corporations Act, there is currently no broad ASIC exemption and modification power in respect of the amended provisions. These parts only contain specific ASIC exemption powers in relation to certain sections (eg section 257D(4) under Part 2J.1 in relation to special shareholder approval for selective buy-backs). A broad exemption and modification power, administered by ASIC, should be implemented to deal with the “known unknowns” that may arise for MCI mutual entities. The power granted to ASIC could be drafted in similar terms to section 655A (Chapter 6) or section 340 (Parts 2M.2, 2M.3 and 2M.4 (other than Division 4)). Ideally, this exemption power would be coupled with updated regulatory guidance from ASIC.

KING&WOOD MALLESONS

We are providing these comments, suggestions and queries on behalf of our firm, and the views expressed are our own and not those of our clients (although we expect that some, if not all, of these issues may have been raised with Treasury by a number of our clients).

We would welcome the opportunity to discuss any aspect of our submission with Treasury. Please contact Jo Dodd (02 9296 2154; jo.dodd@au.kwm.com), Rhys Casey (07 3244 8062; rhys.casey@au.kwm.com) or Ian Paterson (03 9643 4237; ian.paterson@au.kwm.com) if you wish to do so.

Yours faithfully