



HM Treasury

# Mutual deferred shares:

consultation on technical  
policy details

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August 2016





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# 1 Introduction

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## Purpose of the consultation

**1.1** This consultation invites views on the government's proposed Mutuals' Deferred Shares Regulations, which will allow mutual insurers to issue this new type of capital created by the Mutuals' Deferred Shares Act 2015.

**1.2** This consultation should be read by those who will seek to take advantage of the regulations and issue a mutual deferred share, or who could be affected by this. This could be any individual, organisation or group that is a stakeholder in the UK mutual insurance market, such as friendly societies, mutual insurers, professional advisers, business groups, consumer groups, investors, individual mutual members, and other interested parties.

## Background

**1.3** Friendly societies and mutual insurers have existed in the UK for hundreds of years. Their origins lie in community networks, where a group of people contributed to a mutual fund that could support them at a time of need. Mutuals are owned by their members and operate some form of democratic voting system, with each member carrying the same weight. This contrasts with shareholder owned companies, where customers and owners are distinct and votes are distributed according to capital ownership. By the late 1900s there were around 27,000 mutual societies.<sup>1</sup>

**1.4** Given their business model, insurance mutuals were not designed with capital markets investors in mind. Participation in the mutual was generally not for financial gain, and capital invested in it could not normally be recovered. This long-term approach adopted by mutuals is often seen as a strength of the sector, as the patient build-up of a surplus retained for the benefit of members can allow a mutual to concentrate entirely on its business and customers rather than meeting the often different needs of external investors.

**1.5** However, today's insurance mutuals operate in a market which is very different to that of their predecessors. Shareholder-owned companies are now the norm, and external capital raising is often an essential component of insurers' growth and investment. Like all business, mutuals can borrow against future earnings if they wish to raise additional funds. However, they are unable to issue shares, which prevents them accessing a much wider pool of long-term capital via the equity markets.

**1.6** This means that mutuals' flexibility to respond to new market conditions is constrained. In the 1990s and early 2000s, there was a wave of demutualisations, and by 2011 mutual insurers made up about 5% of the total UK insurance market, with approximately £86 billion of funds under management.<sup>2</sup> This is in contrast to what is found in continental Europe, where mutuals are far more prevalent and in some cases constitute over half the insurance market.<sup>3</sup> While the recent UK outlook has been more positive, a key challenge for growth and effective competition with other UK insurers remains the lack of access to external capital.

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<sup>1</sup> Association of Financial Mutuals, February 2014, "Mutuals in their Communities – The contribution of friendly societies and mutual insurers to the communities they work in".

<sup>2</sup> Deloitte, November 2011, "Future Proofing the UK Mutual Insurance Sector – The need to think strategically".

<sup>3</sup> International Cooperative and Mutual Insurance Federation data as presented in the European Parliament 2011 paper "The Role of Mutual Societies in the 21<sup>st</sup> century."

## The Mutuals' Deferred Shares Act 2015

**1.7** The Mutuals' Deferred Shares Act 2015 – originally a Private Member's Bill – sought to address the challenges above by legislating for mutual insurers to be able to issue a new type of capital instrument. It received cross party support in both the House of Commons and House of Lords and received Royal Assent in March 2015.

**1.8** The Act includes two key sections:

- Section 1 gives a power to HM Treasury to make regulations which permit the issue of mutual deferred shares by a friendly society or mutual insurer.<sup>4</sup> Prior consent of the relevant regulators must be obtained before mutuals are able to issue the shares. It also gives HM Treasury powers to specify further characteristics of mutual deferred shares, noting that these are not the same as shares within the meaning of the Companies Act 2006.
- Section 2 aims to preserve some of the key characteristics of mutuals despite being able to issue mutual deferred shares. Mutuals will be able to provide membership rights to shareholders, but will not be able to grant more than one vote per shareholder member and no shareholder member will receive more votes than a non-shareholder member by virtue of being a shareholder member<sup>5</sup>. In addition shareholder members cannot vote in certain processes which might result in demutualisation.

**1.9** This consultation concerns the Treasury regulations to define the characteristics of mutual deferred shares. The Treasury has worked closely with regulators and interested parties in the industry to discuss the detailed process for issuing deferred shares, how to ensure compliance with regulatory requirements, and how to balance the interests of shareholder members and non-shareholder members. The draft regulations aim to provide a basic level of clarity and consistency regarding the characteristics of mutual deferred shares in order to support the development of a coherent market. It will be for mutuals themselves to determine the detailed terms and conditions of individual share issues.

## Structure of the consultation

**1.10** The remainder of this consultation is structured as follows:

- chapter 2 explains the main features of the regulations and asks a number of questions about policy issues involved in their drafting
- chapter 3 explains the estimated impact on business that the regulations could have, and seeks feedback to improve this assessment
- chapter 4 explains some high-level tax questions that may arise for mutuals issuing mutual deferred shares, which will need to be the subject of future work
- annex A contains a full draft of the Mutuals' Deferred Shares Regulations
- annex B summarises the consultation questions and explains how to respond to the consultation

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<sup>4</sup> As defined in Section 3 of the Act.

<sup>5</sup> For the purposes of this paper the following definitions are used: shareholder members are mutual members by virtue of holding mutual deferred shares; non-shareholder members are mutual members by virtue of being customers of the mutual. Members refers to the totality of mutual members.

## Next steps

**1.11** The consultation will run until 30 September 2016. The government will then consider the responses received, with the intention of finalising the regulations and incorporating any necessary changes. It will then publish a statement of its conclusions from the consultation, before laying the final regulations in Parliament supported by a final impact assessment. The Act specifies that the regulations will be subject to an affirmative vote of both Houses to approve them before they can come into force. Overall, it is expected that this process may take until the end of 2016.

**1.12** The government expects that the financial regulators may develop additional guidance on mutual deferred shares. The Financial Conduct Authority (FCA) said in 2015 that it would keep the market under review and consider introducing requirements for the retail distribution of mutual insurers' deferred shares if they deemed it necessary.<sup>6</sup> The FCA may consult on appropriate rule changes in due course. The Prudential Regulation Authority (PRA) has previously issued a number of supervisory statements about insurers' capital and, following the finalisation of the mutual deferred shares regulations, may consult on a supervisory statement outlining its expectations for how mutual insurers can demonstrate they meet the conditions for issuance and gain PRA consent.

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<sup>6</sup> <https://www.fca.org.uk/static/documents/policy-statements/ps15-14.pdf>



## 2 Design of the shares

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**2.1** The aim of the draft regulations is to provide a minimum level of clarity and consistency about the characteristics of mutual deferred shares. This is intended to help facilitate the development of a coherent market, assist in compatibility with regulatory requirements,<sup>1</sup> and ensure an appropriate balance between the interests of shareholder members and non-shareholder members.

**2.2** The remainder of this chapter goes through some of the key features of the regulations step-by-step. It is intended to help explain some of the main policy thinking behind the drafting of the regulations, but does not cover every aspect. Those responding to the consultation, particularly those who may be involved in legal issues concerning mutual deferred shares, may want to consider the full draft regulations in Annex A when formulating their views.

### Types of mutual deferred share

**2.3** Regulation 2 and 3 of the regulations sets out two categories of mutual deferred shares, to be known as 'ordinary' and 'preference'. Some of the key drafting is reproduced in Box 2.A. The main difference between the types of share is in the degree of subordination of the shareholder members' interests. The interests of 'ordinary' shareholders rank equal to the interests of non-shareholder members of the mutual, while those of 'preference' shareholders rank just above; both rank below policyholders and non-subordinated creditors.

**2.4** Different mutuals may prefer to issue one type of share or the other depending on their constitutions, intended investors and business aims. 'Preference' shares potentially allow for a clearer definition of shareholder members' distinct interests compared to non-shareholder, but only 'ordinary' shares have the potential to qualify as unrestricted or core tier one capital for the purposes of prudential regulation.

**2.5** The regulations specify that issuers can only issue one type of share. Distinguishing between the rights of policyholders, non-shareholder members, ordinary shareholder members and preference shareholder members in a mutual could be highly complex. It may negatively affect the transparency and consistency of mutual deferred shares as a new financial instrument, especially if intended to be marketed to less sophisticated investors. However, the government is open to reviewing this restriction as the market develops.

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<sup>1</sup> In particular, to ensure that mutual deferred shares have the potential to qualify as tier one capital under the EU's Solvency II Directive or the Prudential Regulation Authority's rulebook for non-Directive insurers.

### Box 2.A: Types of mutual deferred share

“Ordinary deferred shares” means deferred shares which provide that the shareholder member participates in any members’ funds in proportion to their financial interest in the issuer in the event of winding up or dissolution of the issuer, where that financial interest is the nominal value of the shares.

“Preference deferred shares” means deferred shares which provide that the shareholder member’s financial interest ranks ahead of the financial interests of non-shareholder members in any members’ funds in the event of the winding up or dissolution of the issuer, where that financial interest is capped at the nominal value of the share.

An issuer may issue either ordinary deferred shares or preference deferred shares, but not both.

Deferred shares must provide for the shareholder member’s financial interest to rank behind those of policyholders and non-subordinated creditors.

**Do you agree with the definitions and limitations on the two types of mutual deferred share?**

## Conditions for issuance of mutual deferred shares

**2.6** Regulation 4 sets out some essential conditions for the issuance of a share. Some of the key drafting is reproduced in Box 2.B. The conditions on issuance include:

- a vote of existing members to allow the share issue, as this would be a major change for the mutual
- provision for the share issue in the issuer’s constitution, so that any significant implications for the mutual’s objectives and structure are codified
- ensuring that members of the issuer are well informed about the consequences of a share issue, for example the risks and rewards of raising new capital from shareholder members
- defining members’ funds, which must exclude assets corresponding to policyholders’ interests and explain the distinction between shareholder and non-shareholder members in their rights to the members’ funds. This is to ensure that all parties are clear on their rights on winding up and for the purpose of any distributions
- defining the intended regulatory treatment of the members’ funds, so that the impact of a share issue on the mutual’s regulatory solvency is clear
- securing the consent of the PRA or FCA (or both, for dual regulated firms), as required by the Act and discussed further below

**2.7** The definition of members’ funds may be a complicated exercise, especially in mutuals with with-profits business run out of a common fund in which any members’ funds are also held.<sup>2</sup> The regulations are not intended to change any of the existing considerations which may apply to the clarification of the various member and policyholder interests in a mutual, only to require that a definition is established prior to issuing mutual deferred shares. It is expected that the PRA and FCA will take a close interest in whether the definition is satisfactory when exercising their power of consent.

<sup>2</sup> The FCA and PRA have each published statements of their views on the considerations that may apply. See [www.fca.org.uk/static/documents/policy-statements/ps14-05.pdf](http://www.fca.org.uk/static/documents/policy-statements/ps14-05.pdf) and [www.bankofengland.co.uk/prd/Documents/publications/ss/2015/ss114update.pdf](http://www.bankofengland.co.uk/prd/Documents/publications/ss/2015/ss114update.pdf).

### **Box 2.B: Conditions for issuance of mutual deferred shares**

An issuer has defined the funds [members' funds] to which members have a claim in the event of winding up or dissolution of the issuer and from which any distributions will be paid, including the basis on which such payments will be apportioned amongst members.

An issuer has distinguished the respective claims to the members' funds [for the purposes above] of shareholder members and members who are not shareholder members.

An issuer has provided that none of the issuer's assets corresponding to the interests of policyholders in their capacity as policyholders shall constitute members' funds.

An issuer has defined what form of capital the members' funds will constitute and the treatment of such capital under the prudential rules that apply to the issuer.

Members have voted in accordance with the constitution, memorandum or rules of the issuer (as applicable) to allow the share issue.

The constitution, memorandum or rules of the issuer (as applicable) must provide for the share issue.

The issuer must have submitted an application to the relevant authority for consent to the share issue and the relevant authority must have consented to the share issue.

**Do you agree with the conditions for issuance of mutual deferred shares?**

## **Distributable items**

**2.8** Regulation 2 defines a number of the terms used in the regulations. One significant definition is the concept of 'distributable items' i.e. the source of any dividend-like payments to holders of mutual deferred shares or to non-shareholder members as provided for in the issuer's constitution. The concept of 'distributable items' is defined by reference to the definition of 'profits available for distribution' in section 830 of the Companies Act 2006, which is reproduced in Box 2.C.

**2.9** This will be a subset of the members' funds defined in regulation 4. It will include that part of the mutual's historical surplus attributable to members together with future profits attributable to members but will exclude capital raised from mutual deferred shares. There is no restriction on mutuals narrowing the source of distributions to shareholders further, either in their constitutions or in the terms of any share issue.

### **Box 2.C: Definition of 'profits available for distribution'**

A company's profits available for distribution are its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made.

**Do you agree with the approach to defining distributable items?**

## Additional features – ordinary mutual deferred shares

**2.10** Regulation 5 includes provisions that set out some additional features of each of the two types of mutual deferred shares to ensure they have the potential to qualify as tier one regulatory capital for the purposes of prudential regulation.

**2.11** For ordinary mutual deferred shares, the intention is that they should have the potential to qualify as unrestricted or core tier one capital. The key drafting is reproduced in Box 2.D. In general terms, it requires that:

- the value of the shares is immediately available to the issuer
- there is no direct or indirect obligation on the issuer to pay distributions on the shares
- there is no requirement to make distributions to shareholder members ahead of distributions to the non-shareholder members with whom they rank equally in the capital structure

### Box 2.D: Regulatory requirements for ordinary deferred shares

The shares are to be fully paid up by the shareholder member at the time of issue.

The nominal value of the share cannot increase from its value as set at the time of issue.

The issuer must retain full flexibility over any distributions, which requires that –

- there is no obligation for the issuer to make any distribution
- if any distribution to members is made, there is no requirement to make distributions to shareholder members ahead of, or on terms more favourable than, distributions to other members
- the cancellation of distributions imposes no restriction on the issuer
- non-payment of distributions does not constitute any default on the part of the issuer
- the level of distribution on each share is not determined on the basis of the amount for which the share was purchased at issue
- distributions are paid out of distributable items

Do you agree with the proposed features of ordinary mutual deferred shares?

## Additional features – preference mutual deferred shares

**2.12** For preference mutual deferred shares, the intention is that they should have the potential to qualify as restricted or non-core tier one capital for the purposes of prudential regulation.<sup>3</sup> The key drafting from regulation 5 is reproduced in Box 2.E. This differs from the requirements for ordinary mutual deferred shares in two respects:

- while there must be no obligation on the issuer to pay distributions, distributions may be paid to preference mutual deferred shareholders ahead of non-shareholder members

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<sup>3</sup> This means they can constitute at most 20% (for Solvency II insurers) or 50% (for non-directive insurers) of the mutual's tier one capital.

- for firms subject to Solvency II, to qualify as restricted tier one capital preference mutual deferred shares must include provision for a write-down mechanism that imposes losses on the shareholders in the event of the mutual breaching the relevant regulatory triggers

**2.13** The write-down mechanism is chosen in preference to conversion into ordinary deferred shares in order to avoid the complications and uncertainty, as discussed above, that would arise in a mutual that could potentially have both preferred and ordinary mutual deferred shareholders. Note also that there is no requirement for a write-down mechanism for firms which are not subject to Solvency II.

#### **Box 2.E: Regulatory requirements for preference mutual deferred shares**

The shares are to be fully paid up by the shareholder member at the time of issue.

The nominal value of the share cannot increase from its value as set at the time of issue.

The issuer must retain full flexibility over any distributions, which requires that:

- the issuer has full discretion to cancel distributions and has no obligation to substitute for the distribution a payment in any other form
- there is no obligation to make any distribution in the event of a distribution being made on any other item issued by that issuer
- non-payment of distributions does not constitute any default on the part of the issuer
- the cancellation of distributions imposes no restriction on the issuer
- distributions are paid out of distributable items

On the occurrence of a trigger event of significant non-compliance with the Solvency Capital Requirement as described in Article 71(8) of Commission Delegated Regulation (EU) 2015/35 (where that requirement applies to the issuer), provision is made for the write down of the share, where write down means that the nominal amount of the share is written down so that all of the following are reduced:

- the claim of the shareholder member in the event of winding up proceedings
- the amount required to be paid on redemption of the share
- any distributions payable on that item

**Do you agree with the proposed features of preference mutual deferred shares?**

## **Regulators' consent**

**2.14** Regulations 6 to 8 explains how the regulators' power of consent should be exercised. The regulators must consider whether an issuer has met the relevant requirements in regulation 4 (conditions for issuance) and regulation 5 (features of mutual deferred shares), and the impact of the share issue on the regulators' objectives. A process for decision notices and for appeals is also provided for.

**2.15** Detailed drafting of these regulations can be found in Annex A.

**Do you agree with the criteria and process for the regulators' consent?**

## Voting restrictions

**2.16** Regulations 5(1)(a) and 9 fulfil the requirement of the Act that the regulations providing for the issue of mutual deferred shares must not change the 'one member one vote' structure of mutuals' decision-making and must prevent shareholder members from voting in processes that could be used as a route to demutualisation. Detailed drafting can be found in Annex A.

**2.17** In votes on other matters, for example amendments to the mutual's constitution or decisions in relation to mutual deferred shares, there are no restrictions on the participation of mutual deferred shareholders as none are envisaged in the Act. This means that mutual deferred shareholders may exercise an influence over the mutual's operations.

**Do you agree with the voting restrictions on mutual deferred shareholders?**

## Other provisions

**2.18** Regulation 10 obliges the Treasury to review the regulations and report on them within 5 years of them coming into force and at five year intervals thereafter. This is intended to be a sufficient time for the market to begin to develop and provides an opportunity to review whether mutual deferred shares are operating as intended.

**2.19** The Schedule to the regulations makes a number of changes to primary legislation to accommodate the issuance of mutual deferred shares. In particular, it clarifies that elements of the Companies Act 2006 relating to the maintenance of share registers and the transfer of securities will apply to mutual deferred shares.

**2.20** Not every detail of the draft regulations has been discussed here, but a full draft is enclosed in Annex A. Those responding to the consultation, especially those who may be involved in legal issues in relation to mutual deferred shares, may wish to consider the full draft in formulating their response to the consultation.

**Do you have any comments on the other provisions of the regulations?**

# 3 Impact on business

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**3.1** The government is firmly committed to ensuring that the overall regulatory burden on business is minimised and that new regulatory proposals impose the minimum necessary burdens on business to achieve their aims.

**3.2** The Mutual Deferred Shares Act 2015 empowers HM Treasury to issue regulations applying to the issuance of mutual deferred shares, but it does not require mutuals to issue these new types of capital instruments. This means that the burden of the regulations will only fall on those firms that judge there is an overall benefit from issuing mutual deferred shares. It is therefore highly likely that the overall impact of the regulations will be positive.

**3.3** At this stage it is difficult to put exact figures on the costs and benefits of the regulations, but the initial expectations presented to government by the industry are as follows:

- up to 10 of the larger firms within the sector could initially take advantage of the regulations and issue a mutual deferred share
- industry representatives have estimated that the cost of issuance, only part of which relates to meeting the requirements of the regulations, would be a one-off amount of approximately £100,000 for each firm
- the ongoing costs of compliance with the direct requirements of the regulations are estimated to be negligible; the only explicit requirement is adding shareholders to the members' register that mutuals already maintain
- industry representatives have suggested that an issue by a large mutual could raise between £70 million and £100 million of additional capital to grow the business

**3.4** The government recognises that there are a number of uncertainties in this analysis. For example:

- some mutuals may need to undergo significant restructuring to make use of mutual deferred shares
- smaller mutuals may need additional external support to issue mutual deferred shares
- additional reporting may be required to aid transparency, imposing certain additional administrative costs
- issuance sizes could be higher or lower depending on investor demand
- costs may change as the market develops and standard practices emerge

**3.5** In finalising the regulations, the government will prepare a full impact assessment. The government would therefore welcome further feedback from industry about the potential costs and benefits of issuing mutual deferred shares, and specifically about the direct impact of the draft regulations, to help refine the impact assessment. It would also welcome comments on whether any features of the regulations could be made less burdensome while remaining consistent with the policy aims. Specific analysis and figures on the following would be particularly helpful:

- **What up-front and ongoing costs would an individual mutual face to issue mutual deferred shares, and which of these arise directly from the regulations?**

- What quantifiable financial benefits would a mutual obtain from issuing mutual deferred shares, over what period, and which of these would not be possible without the regulations?
- How many mutuals plan to issue mutual deferred shares, in what volume, and how frequently?

# 4 Taxation

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**4.1** Mutual deferred shares are a significant innovation in the funding of mutuals' activities and may have implications for how mutuals are taxed. These tax issues are not the subject of this consultation and can only be fully considered once the design of mutual deferred shares has been settled. The tax treatment may also depend on the features of particular share issues as decided by individual mutuals. However, this chapter airs a number of questions that mutuals may wish to consider in formulating plans for the issuance of mutual deferred shares.

**4.2** At the moment, mutual insurers' trading surplus is exempt from Corporation Tax and distributions to members are exempt from Income Tax. This is because of the long-standing principle that members of a mutual are not engaged in a trade that generates a profit – one cannot 'trade with oneself'. This is consistent with the membership structure of current mutuals where the members of the mutual are also its customers. This basic principle of mutuality is reflected in HMRC's tax manual, and is ultimately drawn from case law.<sup>1</sup>

**4.3** A mutual that issues mutual deferred shares may challenge this basic principle. Shareholder members may not be customers of the mutual. Their interest in the mutuals' activities would be principally a financial one, as external investors. It is arguable that, at least to the extent the mutual's activities are intended to generate a surplus for distribution to external investors, the mutual is now engaged in trade to make a profit. It may be difficult to sustain the present tax exemptions for mutuals in these circumstances.

**4.4** Mutuality is a common law principle and it is ultimately for the courts to decide what does or does not constitute mutual activity. But in an extreme case, where a mutual is overwhelmingly funded by mutual deferred shares and its surplus is distributed to the shareholders, there would be no return of surplus to non-shareholder members as contributors and so the link between the surplus and those members is broken. It would be highly likely that the firm would cease to be regarded as a mutual. Its surplus would become subject to Corporation Tax, and any distributions would be taxable in the hands of the recipient.

**4.5** Real-life cases are likely to be less clear-cut, and it will require a detailed understanding of how mutuals intend to issue mutual deferred shares, to whom, and in what volumes to reach any general conclusions. However, the government believes that the emergence of mutual deferred shares will almost certainly require a careful examination of the taxation of the mutuals using them and the investors receiving distributions on them. Precedents from other mutuals that have raised external capital, such as building societies, may provide a partial guide, although building societies' surpluses are already subject to Corporation Tax. The government would welcome thoughts from the industry on this issue to inform future work.

**Do you have any views on the potential tax implications of the issuance of mutual deferred shares?**

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<sup>1</sup> <http://www.hmrc.gov.uk/manuals/bimmanual/BIM24025.htm>



# A Draft regulations

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**A.1** This annex contains a full draft of the Mutuals' Deferred Shares Regulations.



“members’ funds” means the shareholder members’ funds and the funds of members who are not shareholders as described in regulation 4(2)(a);

“non-subordinated creditors” means creditors of the issuer whose debt takes priority over the subordinated debt of creditors of the issuer;

“ordinary deferred shares” means deferred shares which provide that the shareholder member participates in any members’ funds in proportion to their financial interest in the issuer in the event of winding up or dissolution of the issuer, where that financial interest is the nominal value of the shares;

“own funds” has the meaning in Articles 87 to 89 of Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II);

“policyholder” means a person who for the time being is the legal holder of an insurance policy entered into with the issuer, and includes any person to whom, under that policy, a sum is due, a periodic payment is payable or any other benefit is provided or to whom such a sum, payment or benefit is contingently due, payable or to be provided;

“preference deferred shares” means deferred shares which provide that the shareholder member’s financial interest ranks ahead of the financial interests of other members in any members’ funds in the event of the winding up or dissolution of the issuer, where that financial interest is capped at the nominal value of the share;

“PRA” means the Prudential Regulation Authority;

“relevant authority”, in relation to an issuer, means—

- (a) the appropriate authority, or
- (b) if the issuer is a dual-regulated issuer, the PRA and the FCA to the extent required for the advancement of their statutory objectives;

“shareholder member” means a member of the issuer by virtue of being a holder of a mutual deferred share of that issuer;

“the Tribunal” means the Upper Tribunal; and

“transfer of the issuer for the purposes of demutualising the issuer” means a transfer by a mutual insurer of all, or substantially all, of its business consisting of the effecting or carrying out of contracts of insurance to an insurance company which is not a mutual insurer.

### **Deferred shares**

3.—(1) An issuer may issue either ordinary deferred shares or preference deferred shares, but not both.

(2) Deferred shares must provide for the shareholder member’s financial interest to rank behind those of policyholders and non-subordinated creditors.

### **Conditions for issue of mutual deferred shares**

4.—(1) An issuer must satisfy the conditions in this regulation before deferred shares can be issued.

(2) The issuer must—

- (a) define the funds—
  - (i) to which members have a claim in the event of winding up or dissolution of the issuer;
  - (ii) from which any distributions will be paid, including the basis on which such payments will be apportioned amongst members;
- (b) distinguish the respective claims to the members’ funds under paragraph (2)(a)(i) and (ii) of—
  - (i) shareholder members; and

- (ii) members who are not shareholder members;
  - (c) provide that none of the issuer's assets corresponding to the interests of policyholders in their capacity as policyholders shall constitute members' funds;
  - (d) define what form of capital the members' funds will constitute and the treatment of such capital under the prudential rules that apply to the issuer; and
  - (e) notify its members of the terms of the proposed share issue to enable them to make an informed decision about what is proposed as regards the share issue.
- (3) Members must have voted in accordance with the constitution, memorandum or rules of the issuer (as applicable) to allow the share issue.
- (4) The constitution, memorandum or rules of the issuer (as applicable) must provide for the share issue.
- (5) The issuer must have submitted an application to the relevant authority for consent to the share issue and the relevant authority must have consented to the share issue.

### **Features of a deferred share**

**5.—(1)** A share must include all of the following features in order to constitute a deferred share for the purposes of these Regulations—

- (a) a shareholder may only become a shareholder member of the issuer once one or more deferred shares has been allotted to them by the issuer, subject to the following conditions—
  - (i) the shareholder member not obtaining more than one vote in total as a member from the issuer by virtue of being a holder of those shares;
  - (ii) the shareholder member not gaining any additional voting rights by virtue of being a holder of those shares where the shareholder was a member of the issuer prior to becoming a shareholder member; and
  - (iii) the shareholder member being prevented from exercising their voting right as a shareholder member in relation to any vote or resolution in connection with a transfer of the issuer for the purposes of demutualising the issuer;
- (b) the shares are to be fully paid up by the shareholder member at the time of issue;
- (c) the nominal value of the share cannot increase from its value as set at the time of issue;
- (d) the issuer must retain full flexibility over any distributions, which means that –
  - (i) distributions are paid out of distributable items;
  - (ii) the cancellation of distributions imposes no restriction on the issuer; and
  - (iii) non-payment of distributions does not constitute any default on the part of the issuer.

(2) In the case of ordinary mutual deferred shares, the issuer's obligation in paragraph (1)(d) to retain full flexibility over any distributions must also mean that—

- (a) the level of distribution on each share is not determined on the basis of the amount for which the share was purchased at issue;
- (b) if any distribution to members is made, there is no requirement to make distributions to shareholder members ahead of, or on terms more favourable than, distributions to other members; and
- (c) there is no obligation for the issuer to make any distribution.

(3) In relation to preference mutual deferred shares, in addition to the features contained in paragraph (1)(a) to (d), a share must also include the following features in order to constitute a deferred share for the purposes of these Regulations—

- (a) on the occurrence of a trigger event of significant non-compliance with the Solvency Capital Requirement as described in Article 71(8) of Commission Delegated Regulation

(EU) 2015/35(a) (where that requirement applies to the issuer), provision is made for the write down of the share;

- (b) the issuer's obligation in paragraph (1)(d) to retain full flexibility over any distributions must also mean that—
  - (i) the issuer has full discretion to cancel distributions and has no obligation to substitute for the distribution a payment in any other form; and
  - (ii) there is no obligation to make any distribution in the event of a distribution being made on any other item issued by that issuer.

(4) For the purposes of paragraph (3)(a), write down means that the nominal amount of a share is written down so that all of the following are reduced—

- (a) the claim of the shareholder member in the event of winding up proceedings;
- (b) the amount required to be paid on redemption of the share; and
- (c) any distributions payable on that item.

### **Consent of the relevant authority**

6. The relevant authority must consent to an application under regulation 4(5) to issue deferred shares where they are satisfied that—

- (a) the conditions in regulation 4(2) to (4) have been met;
- (b) the shares, if issued, would contain the features described in regulation 5;
- (c) the share issue would not adversely affect the advancement of—
  - (i) the FCA's operational objectives as defined in section 1B(3) of FSMA, if the FCA is a relevant authority; or
  - (ii) the PRA's objectives as defined in sections 2B and 2C of FSMA, if the PRA is a relevant authority.

### **Decisions: written notices**

7. On determining an application for consent to the issue of deferred shares, the relevant authority must give the issuer a written notice stating—

- (a) its decision;
- (b) the reasons for the decision; and
- (c) if consent is granted, the date on which that consent takes effect and the conditions (if any) to which that consent is subject.

### **Appeals**

8. (1) If aggrieved about the decision of a relevant authority in relation to an application under regulation 4(5), the applicant may refer the matter to the Tribunal.

(2) Part 9 of FSMA (hearings and appeals) applies to a reference to the Tribunal under this regulation as it applies to a reference to the Tribunal under FSMA.

### **Disapplication of provisions granting voting rights**

9. The following provisions do not apply to shareholder members who gain voting rights in the issuer by virtue only of being a member in that capacity—

- (a) in the case of issuers which are friendly societies, entitlement to vote in a resolution under sections 85(a) (amalgamation of friendly societies), 86(b) (transfer of engagements by or

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(a) O.J. No. L 12/1 17.1.2015, supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

to a friendly company) or 91(c) (conversion of friendly society into company) of the Friendly Societies Act 1992(d);

- (b) in the case of issuers to which the Companies Act 2006 applies—
  - (i) the provisions of Part 26 (arrangements and reconstructions) insofar as a member can propose or vote on a compromise or arrangement;
  - (ii) participation in consent to a variation or entitlement to vote on a resolution under section 631 (variation of class rights: companies without a share capital) or an application to court for cancellation of a variation under section 634 (right to object to variation: companies without a share capital), unless the class of members concerned is the shareholder members;
- (c) in the case of issuers to which section 110 of the Insolvency Act 1986(e) (acceptance of shares, etc, as consideration for sale of company property) applies, or, in Northern Ireland, to which Article 96 of the Insolvency (Northern Ireland) Order 1989(f) (acceptance of shares, etc, as consideration for sale of company property) applies, the provisions of that section or article in relation to any arrangement made.

## Review

10.—(1) The Treasury must from time to time—

- (a) carry out a review of regulations 3 to 9;
- (b) set out the conclusions of the review in a report; and
- (c) publish the report.

(2) The report must in particular—

- (a) set out the objectives intended to be achieved by the regulatory system established by regulations 3 to 9;
- (b) assess the extent to which those objectives are achieved; and
- (c) assess whether those objectives remain appropriate and, if so, the extent to which they could be achieved with a system that imposes less regulation.

(3) The first report under this regulation must be published before the end of the period of five years beginning with the day on which these Regulations come into force.

(4) Reports under this regulation are to be published at intervals not exceeding five years.

## Modification

11. The Schedule, which contains modifications to primary legislation, has effect.

Name

Date

Two of the Lords Commissioners of Her Majesty's Treasury

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(a) Section 85 was amended by S.I. 2010/22, S.I. 2001/2617 and S.I. 2013/496.  
(b) Section 86 was amended by S.I. 2001/3649, S.I. 2009/1941, S.I. 2011/593 and S.I. 2013/496.  
(c) Section 91 was amended by S.I. 2001/2617, S.I. 2009/1941 and S.I. 2013/496.  
(d) 1992 c.40.  
(e) 1986 c.45. Section 110 was amended by S.I. 2001/1090, S.I. 2009/1941 and S.S.I. 2001/128  
(f) 1989 No. 2405 (N.I. 19). Section 96 was amended by S.I. 2009/1941.

## Modifications to primary legislation

**FSMA**

1. The functions of the FCA under these Regulations are to be treated for the purposes of FSMA as functions of the FCA under that Act.

2. The functions of the PRA under these Regulations are to be treated for the purposes of FSMA as functions of the PRA under that Act.

**Companies Act 2006**

3. Section 113(3) of the Companies Act 2006 (register of members) applies to a company which has issued deferred shares and its deferred shares as it applies to a company with share capital and its shares.

4. Part 21 of the Companies Act 2006 (certification and transfer of securities) applies to deferred shares as it applies to shares within the meaning of that Act.

**EXPLANATORY NOTE**

*(This note is not part of these Regulations)*

These Regulations make provision for friendly societies and mutual insurers to issue a new type of capital instrument known as a deferred share. Regulation 3 enables the shares to be issued as either an ordinary deferred share or a preference deferred share, the difference between them being the ranking of the share on winding up of the issuer.

Regulation 4 sets out certain conditions which must be satisfied before deferred shares can be issued, to ensure that members of the issuer are fully aware of the financial implications of and possible impacts on all members of the issue of deferred shares, including an obligation on the issuer to define the funds to which shareholder members and other members have a claim in the event of winding up or dissolution of the issuer and to require that the constitution, memorandum or rules of the issuer (as applicable) are amended in accordance with the existing rules to provide for their issue.

Regulation 5 sets out the features that are required for shares to constitute deferred shares for the purposes of these Regulations.

Regulation 6 sets out the circumstances in which the appropriate authority is to consent to a request from an issuer to issue deferred shares.

Regulations 7 and 8 set out the procedure for written decisions and appeals in relation to applications to the appropriate authority for consent to an issue of deferred shares.

Regulation 9 restricts the voting and other rights of the holders of deferred shares in certain circumstances where the exercise of those rights might otherwise enable the demutualisation of the relevant entity.

Regulation 10 requires the Treasury to review the operation and effect of these Regulations and publish a report within five years after they come into force and within every five years after that.

The Schedule contains modifications to relevant provisions of the Companies Act 2006 (c.46) in their application to an issue of deferred shares, and modifications to relevant provisions of the Financial Services and Markets Act 2000 (c.8) in their application to a friendly society or mutual insurer which proposes to issue, or has issued, deferred shares.

A full impact assessment of the effect that these Regulations will have to the costs of business and the voluntary sector will be available from Her Majesty's Treasury, 1 Horse Guards Road, London, SW1A 2HQ or on [www.gov.uk](http://www.gov.uk) and will be published alongside these Regulations on [www.legislation.gov.uk](http://www.legislation.gov.uk).

# B How to respond

## Box B.1: Consultation questions

- 1 Do you agree with the definitions and limitations on the two types of mutual deferred share?
- 2 Do you agree with the conditions for issuance of mutual deferred shares?
- 3 Do you agree with the approach to defining distributable items?
- 4 Do you agree with the proposed features of ordinary mutual deferred shares?
- 5 Do you agree with the proposed features of preference mutual deferred shares?
- 6 Do you agree with the criteria and process for the regulators' consent?
- 7 Do you agree with the voting restrictions on mutual deferred shareholders?
- 8 Do you have any comments on other provisions of the draft regulations?
- 9 What up-front and ongoing costs would an individual mutual face to issue mutual deferred shares, and which of these arise directly from the draft regulations?
- 10 What quantifiable financial benefits would a mutual obtain from issuing mutual deferred shares, over what period, and which of these would not be possible without the regulations?
- 11 How many mutuals plan to issue mutual deferred shares, in what volume and how frequently?
- 12 Do you have any views on the potential tax implications of the issuance of mutual deferred shares?

**B.1** The Treasury invites responses on the questions raised in this consultation, as summarised above. This consultation will run from 4 August 2016 to 30 September 2016.

**B.2** Responses are requested by email to [mutualdeferredshares@hmtreasury.gsi.gov.uk](mailto:mutualdeferredshares@hmtreasury.gsi.gov.uk).

**B.3** There is no need to submit hard copies of consultation responses, but if a response cannot be sent by email it can be posted to:

Consultation on Mutuals' Deferred Shares Regulations  
Insurance, Pensions and Regulators team  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

**B.4** When responding please say if you are a business, individual or representative body. In the case of representative bodies, please provide information on the number and nature of people you represent.

## Confidentiality

**B.5** Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1988 (DPA) and the Environmental Information Regulations 2004.

**B.6** If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory code of practice with which public authorities must comply and which deals with, among other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential.

**B.7** If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury.

**B.8** HM Treasury will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.



### **HM Treasury contacts**

This document can be downloaded from  
[www.gov.uk](http://www.gov.uk)

If you require this information in an alternative  
format or have general enquiries about  
HM Treasury and its work, contact:

Correspondence Team  
HM Treasury  
1 Horse Guards Road  
London  
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Tel: 020 7270 5000

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