Ministry of Economic Development

Manatū Ōhanga

REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS:

MUTUALS' GOVERNANCE

Discussion Document

September 2006

ISBN 0478284969

First Published September 2006
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1. TABLE OF CONTENTS

2. GOVERNANCE OF MUTUAL FINANCIAL INSTITUTIONS

2.1 EXECUTIVE SUMMARY

1. Corporate governance refers to the structures and processes by which companies and other entities are directed and controlled. The OECD 2004 Principles of Corporate Governance state that: "Good corporate governance should provide proper incentives to the Board of Management to pursue objectives that are in the interest of the company and its shareholders and should facilitate effective monitoring."

2. In the first stage of the Review of Financial Products and Providers a series of issues were identified around the governance standards of Non-Bank Deposit Taking Institutions (NBDTIs). Comments were received about the varying governance standards relating to NBDTIs with many suggesting that the governance regime set out in the Companies Act 1993 provided a better system for ensuring accountability, through shareholder remedies and processes for the appointment and removal of directors.

3. An earlier review of the Friendly Societies and Credit Unions Act 1982 undertaken in 2004 identified, among other issues, that: the governance regime for credit unions was not as robust as that for finance companies and, to a lesser extent, building societies; that there were weaker statutory rules relating to the accountability of directors; and, that there were fewer statutory qualifications for credit union directors and fewer statutory controls on their appointment and removal than directors of companies.

4. This discussion document reviews the current legal requirements for the corporate governance of mutual financial institutions, which are regulated under the Building Societies Act 1965, the Friendly Societies and Credit Unions Act 1982, the Industrial and Provident Societies Act 1908 and the Mutual Insurance Act 1955. It seeks to identify gaps with these governance arrangements against the OECD Principles and comparisons are also made with the corporate governance requirements under the Companies Act 1993. Matters identified include:

    - an absence of specific prescription that a mutual financial institution is to be managed by a board/committee;
    - weaker statutory rules for qualifications of directors of mutual financial institutions;
    - weak rights enabling members of mutual financial institutions to monitor management;
    - a lack of entrenched powers for holding management to account;
    - a lack of provisions ensuring the equitable conduct of member meetings;
    - differing requirements for the appointment and role of auditors.

5. This discussion document explores the costs and benefits of different options for addressing these gaps to reduce the risk of business failure, the consequences of which can be severe for customers and members, and to increase the overall efficiency of mutual financial institutions.

6. These options include a proposal to set some minimum base level corporate governance requirements for mutual financial institutions (in relation to the rights of members, disclosure and transparency and the role and responsibilities of the board) derived from the corporate governance requirements under the Companies Act 1993 and to adopt these as legal requirements. The discussion document also discusses whether these base level corporate governance requirements should be specified in a single piece of governance legislation for all mutual financial institutions and how variations in governance requirements under mutuals legislation could be dealt with.

7. A further possible enhancement to proposals identified above is also discussed – whether there is a need for corporate governance principles to ensure the good governance of mutual financial institutions. The discussion document discusses the costs and benefits of adopting the Securities Commission's Principles and Guidelines for Corporate Governance in New Zealand, or an annotated version of the Securities Commission's Principles, as a guide.

2.2 INTRODUCTION

8. This discussion document discusses the purposes of governance arrangements for credit unions, friendly societies, building societies, mutual insurance associations and industrial and provident societies that are financial service providers (mutual financial institutions).

2.2.1 What is Corporate Governance?

9. Corporate governance refers to the structures and processes by which companies and other entities are directed and controlled. A report on a review of the corporate governance arrangements that apply to mutual life insurers in the United Kingdom titled *The Myners Review of the Governance of Life Mutuals* (Myners Review), issued in December 2004, described corporate governance as follows:

> *In undertakings in which the management is separate from the owners, governance concerns the checks and balances that ensure that firms are running efficiently and meet the objectives of their owners, be they shareholders in a proprietary firm or members of a mutual. This particularly concerns the delegation of responsibility to management and the means by which the owners or their representatives hold the management to account*.

2.2.2 Review of Friendly Societies and Credit Unions Act 1982

10. On 17 September 2004, the Government announced its decisions on the review of the Friendly Societies and Credit Unions Act 1982 (FSCU Act). The review had identified the following issues with the existing governance regime for credit unions.

    a. The governance regime is not as robust as that for finance companies and, to a lesser extent, building societies. In particular, credit unions are subject to less exacting statutory standards for disclosure of non-financial matters (e.g. disclosure of interests by directors).

b. There are weaker statutory rules relating to the accountability of directors of credit unions. While credit union directors are currently subject to fiduciary duties under common law, these are not specified in the FSCU Act. In particular, the FSCU Act does not impose the duty not to engage in reckless trading.

c. There are fewer statutory qualifications for credit union directors, and fewer statutory controls on their appointment and removal than for directors of companies.

2.2.3 Decisions to Date in the Review of Non-Bank Financial Products and Providers

11. The Ministry also reported last year to the Minister of Commerce in a report entitled *Review of Financial Products and Providers – Stage One: Framework*. In the report, the Ministry noted the following points.

    a. Comments had been received about the varying governance standards relating to Non-Bank Deposit Taking Institutions (NBDTIs).

    b. Many thought the governance regime set out in the Companies Act 1993 (Companies Act) provides a better system for ensuring accountability, through shareholder remedies and processes for the appointment and removal of directors, than the existing governance regimes of many NBDTIs (including those applying to mutual financial institutions).

    c. Mutual organisations view accountability differently from companies. For example, the Ministry noted that credit unions are owned by their customers and that management of mutual financial institutions is often made up of members, who are supposed to run the organisation for the benefit of all the members.

2.3 OUTCOMES SOUGHT

12. We are seeking the following outcomes from improvements to the governance requirements for mutual financial institutions:

    - well governed financial institutions and competent management;
    - robust structures for the management of risk within a financial institution;
    - explicit processes through which investors/consumers can hold management accountable and have effective redress;
    - mechanisms that discourage management from acting in a way to undermine the soundness of the financial institution; and
    - competing interests are managed appropriately.

2.4 REASONS FOR REGULATORY INTERVENTION

2.4.1 Market Failure – Information Asymmetry, Weak Market Discipline

13. The Myners Review suggested that stronger governance requirements for United Kingdom life mutuals were needed for the following reasons.

    a. The power of members in life mutuals is relatively weak compared to that of shareholders, particularly large shareholders in a proprietary company. This is because ownership is widely dispersed, with no individual group able to build a controlling position. Also, it was noted that members frequently lack the information, resources and motivation to actively monitor the firm.

    b. While members can "vote with their feet" in some forms of mutuals, by taking the business elsewhere, this option is not available to members of all life mutuals.

    c. Because they have no tradeable equity, there is no effective market for corporate control of life mutuals which, unlike companies, are less vulnerable or responsive to the disciplines of the threat of hostile takeover or movements in the share price.

    d. The relative weakness of members' powers and absence of equity market disciplines are not compensated for by the strength of other external monitors. Life mutuals tend to be smaller, and the monitoring agencies tend to concentrate on the larger firms.

14. These same considerations would also seem to apply to mutual financial institutions in New Zealand.

2.4.2 Proposals Following the Review of the FSCU Act

15. Two proposals put forward in the review of the FSCU Act are also relevant. One was to relax the FSCU Act requirement for there to be a common basis for membership of a friendly society or credit union (known as the "common bond"). Under the proposal, credit unions will be free to determine their own membership qualification. This proposal is included in the Business Law Reform Bill currently before Parliament.

16. This proposal could increase the membership of, and funds held by, credit unions. This would increase the overall level of exposure of credit unions, but also the numbers of individual members able to monitor the management of credit unions.

17. The other proposal was to give credit unions the option of incorporating. As a result, ownership of credit unions' property will move from individual trustees to the incorporated credit union itself. Trustees are currently subject to fiduciary duties, and a trust deed, which will no longer apply. This arguably creates a need for stronger corporate governance requirements.

2.4.3 New Prudential Regulation Regime

18. A prudential regulation regime for NBDTIs and insurance is currently being consulted on. Additional prudential requirements may be imposed. These prudential requirements could require a higher level of corporate governance requirements for

mutual financial institutions over and above any suggestions made in this discussion document.

2.5 OBJECTIVES OF CORPORATE GOVERNANCE OF MUTUAL FINANCIAL INSTITUTIONS

19. The OECD 2004 Principles of Corporate Governance (OECD Principles) state that: "Good corporate governance should provide proper incentives to the Board of Management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring."

20. Similarly, but more specifically for mutual financial institutions, the Myners Review noted that good corporate governance requires:

    a. Establishing the appropriate relationships (in terms of the delegation and retention of powers and the rights to control) between owners, the board and the executive, which is in part determined by the law under which mutuals are established and their rules;

    b. Effective internal monitoring and control of the company and management by the board;

    c. Effective external monitoring by owners, requiring adequate and timely information to be disclosed by the mutual; and

    d. Appropriate powers for owners to hold management to account, again which are determined by the law under which mutuals are established and their rules.

21. The Ministry considers that these objectives provide a good description of the purposes of corporate governance arrangements for mutual financial institutions in New Zealand. The Ministry also considers that the corporate governance arrangements for mutual financial institutions should:

    - provide consumers with the knowledge that all mutual financial institutions are subject to similar base level governance; and

    - allow mutual financial institutions to grow without imposing unacceptable risks on their members.

2.6 ELEMENTS OF COMMON GOVERNANCE REQUIREMENTS FOR MUTUAL FINANCIAL INSTITUTIONS

22. This section considers the current legal requirements for corporate governance of mutual financial institutions, and whether they should be revised.

2.6.1 Current Regulatory Regime

23. Mutual financial institutions are regulated by the Industrial and Provident Societies Act 1908 (IPS Act), the Mutual Insurance Act 1955 (MI Act), the Building Societies Act 1965 (BS Act) and the FSCU Act; together these constitute the Mutuals Legislation.

2.6.1.1 Industrial and Provident Societies

24. Industrial and provident societies are bodies corporate registered under the IPS Act. Members hold shares, with the rights attaching to the shares specified in the society's rules.

25. The IPS Act does not prescribe who manages the society's affairs. This must be set out in its rules.

2.6.1.2 Mutual Insurance Associations

26. Mutual insurance associations (or mutual insurers) are established under the MI Act to provide fire insurance (or other kinds of non-life insurance permitted by regulations) to members. Membership is expressly limited to farmers, co-operative dairy companies and related persons. Members do not have shares.

27. A mutual insurance association is a body corporate, managed by a board of directors. Mutual insurers do not have rules like other societies, except for the purpose of establishing regional divisions. Instead, the MI Act sets out all the applicable corporate governance requirements. These include the procedures for general meetings, that each member has one vote, procedures for the appointment of the board and their responsibilities, and financial reporting requirements.

2.6.1.3 Building Societies

28. Building societies are registered under the BS Act. They are typically established to provide bank-type savings and home loans to members.

29. A building society is a body corporate. Every registered building society is required by the BS Act to have a board of at least two directors, the powers and duties of whom must be set out in the society's rules.

30. Building societies may issue shares, but the BS Act leaves it to the rules of each society to set out the rights attaching to them. The Act also permits a building society's rules to allow a person to become a member without holding a share in the society.

2.6.1.4 Friendly Societies and Credit Unions

31. Friendly societies and credit unions are established under the FSCU Act.

Friendly Societies

32. A friendly society is an unincorporated association established to provide, by voluntary subscriptions or donations, services for any purpose permitted by the FSCU Act.

33. A friendly society's property must be held by trustees, appointed by its members. A person cannot be a secretary or a treasurer and a trustee at the same time.

34. The FSCU Act requires the rules to provide for the appointment of a committee of management.

35. Under the FSCU Act, every member of a friendly society has one vote, subject to any provision in the society's rules giving a chairperson a casting vote. Friendly societies do not issue shares. The rules of friendly societies must set out how the friendly society is to be run.

Credit Unions

36. A credit union is an unincorporated co-operative financial organisation set up to provide savings and loan facilities to its members who have a "common bond" permitted by the FSCU Act. The objects of a credit unions are, generally, to encourage saving by members.

37. Every credit union must issue at least one share to each member. The shares must rank evenly. Every member of a credit union has one vote, subject to any provision in the credit union's rules giving a chairperson a casting vote.

38. A credit union's requirements in relation to trustees and the committee of management are generally the same as for friendly societies. As with friendly societies, all property of a credit union is held by its trustees.

2.6.1.5 Existing Corporate Governance Principles and Guidance

39. There are a number of other corporate governance principles which, while not legally enforceable, are relevant to mutual financial institutions. These include:

    a. The Securities Commission Principles and Guidelines for Corporate Governance in New Zealand (Securities Commission Principles), which apply to issuers.

    b. The Association of Mutual Insurers and the Association of Friendly Societies, which have also published guidance on corporate governance principles in the United Kingdom (AMI/AFS Guidance).

    c. The World Council of Credit Union Inc. has also published a set of principles (WCCU Principles).

2.6.2 Problems of Existing Corporate Governance Requirements

40. The paragraphs below identify gaps between the current corporate governance requirements for mutual financial institutions and the purposes of corporate governance requirements discussed above and applicable aspects of the OECD Principles. The OECD Principles are a fairly comprehensive statement of corporate governance requirements. They start with a high-level statement of corporate governance objectives, and develop specific principles for good corporate governance frameworks. The Companies Act incorporates a large number of the OECD Principles which the Ministry considers best reflect what is internationally considered good practice. Comparisons are also made with the corporate governance requirements under the Companies Act.

2.6.2.1 Absence of Specific Prescription that a Mutual Financial Institution is to be Managed by a Board/Committee

41. The Mutuals Legislation is not clear about who is responsible for the management of a mutual. The Companies Act, in contrast, makes the board responsible for managing, or supervising and directing the management, of the company. Only the MI Act specifically provides that the board of directors of a mutual insurance association has the power to manage the insurer. The other Mutuals Legislation contemplates that other mutuals will have a "committee of management" or "board of directors". The powers of these are not prescribed but must be set out in the mutual's rules.

42. This lack of clarity makes it difficult to ensure that any strengthened governance requirements are imposed on the people in the best position, and accountable to members, to ensure that they are followed.

2.6.2.2 Weaker Statutory Rules for Qualifications of Directors

43. The Ministry's review of the FSCU Act noted that "there are fewer statutory qualifications for credit union directors than directors of companies". Indeed, the statutory qualifications for directors (or the committee of management) under all the Mutuals Legislation is similarly weak. In particular, the Mutuals Legislation lacks the prohibitions, under the Companies Act, against minors and undischarged bankrupts becoming directors. Also, the Companies Act allows the court to order that a person may be prohibited from being a director, but the Mutuals Legislation does not.

2.6.2.3 Weak Rights Enabling Members to Monitor Management

44. As discussed above, good corporate governance requires effective external monitoring of management by owners. The Myners Review concluded that the role of members of a mutual insurer is akin to the role of owners like shareholders, in particular their monitoring role, for the following reasons.

    a. Members would share in the assets of the mutual when it was wound up, and traditionally the rules of mutuals had conferred on members the right to vote on the appointment of directors, permit them to requisition business at general meetings and requisition extraordinary general meetings.

    b. Members are uniquely placed to represent the ownership interest in mutual, financial institutions though they differ from shareholders in many respects. Other external monitors exist (regulators, industry bodies etc.) but their interests are different and ultimately cannot substitute completely for direct interest of members, derived from their contractual relationship with the mutual and associated membership rights.

    c. Myners rejects the argument that trustees (like those holding the property of friendly societies and credit unions) render member involvement redundant.

    d. If directors are to perform their duties for the benefit of members, they must have some sort of dialogue with them.

45. The Ministry considers the same reasoning can apply to mutual financial institutions in New Zealand.

46. The OECD Principles provide that, in order for owners to perform this role effectively, the "corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company".

Disclosure of Annual Return and Financial Statements to Members

47. None of the mutual financial institutions are required to send an annual report to members. Members of industrial and provident societies, friendly societies and credit unions may obtain the mutual's annual return and financial statements on request. A summary of a mutual insurer's annual return is gazetted. Building societies may publish their financial statements, auditor's report and directors' report in a newspaper or send a copy to members.

48. Any mutual financial institution that takes deposits will probably fall within the definition of an "issuer" in the Financial Reporting Act 1993. This would require that their financial statements to comply with most of the same content and audit requirements as companies. However, mutual insurers may not be issuers and so are not subject to those same requirements, meaning that members may not have access to the financial information necessary to effectively monitor the performance of the organisation. The Ministry is consulting on whether all insurance providers should be required to comply with the Financial Reporting Act 1993.

Disclosure of Directors' Interests and Related Party Transactions

49. Only the MI Act and BS Act require directors to declare, at the first available board meeting, any direct or indirect interest he or she has in any contract or proposed contract with the mutual insurance association or society. The MI Act goes on to prohibit directors from voting on the contract, except in limited circumstances (section 30C). There is no similar prohibition in the BS Act. There are no ongoing disclosure requirements in either Act. In contrast, under the Companies Act, directors must disclose any interest he, she, an immediate relative or a related party has in a transaction with the company, unless the transaction is in the ordinary course of the company's business. The company must record these disclosures in a register of interests, which is available to shareholders. This reflects the OECD Principles. The WCCU Principles go further, requiring that:

    a. Board members must excuse themselves from discussion and voting on business matters from which they or their family will gain; and

    b. Loans to directors or managers must be approved by the board with no vote by the individual seeking the loan. All such insider loans must be made within the approved credit policy parameters and will be reported on a regular basis to the full board.

Disclosure of Director and Executive Remuneration

50. Also, none of the Mutuals Legislation requires director and executive remuneration to be disclosed. This disclosure allows members to monitor the performance of executives and the board, and to check that directors are not abusing their position. The Companies Act, for example, requires the board to conclude that director remuneration is fair, and disclose the remuneration in the company's register of interest (which is available for inspection by shareholders). Also, the company's annual report must disclose directors' remuneration and the number of executives who earn more than $100,000, in $10,000 bands.

Members' Participation in Fundamental Corporate Changes

51. Finally, the Mutuals Legislation contains very few requirements for members to be informed about, and participate in, fundamental corporate changes, such as a change to the mutual's rules or a major transaction. Only the BS Act and FSCU Act require rule amendments to be approved by members (by special resolution). The IPS Act is not clear, but it appears that the rules could be changed by ordinary resolution of members.

52. In contrast, the Companies Act requires that changes to a company's constitution and major transactions must be approved by special resolution (i.e. 75% of the shareholders entitled to vote and who actually vote on the amendment). The reason for requiring a special majority for constitutional changes is to prevent rights from being removed by simple majority.

2.6.2.4 Lack of Entrenched Powers for Holding Management to Account

53. As discussed above, good corporate governance requires appropriate powers for owners to hold management to account.

Articulation of Directors' Duties

54. By and large, none of the Mutuals Legislation imposes general duties on the directors, although these might be imposed by a mutual financial institution's rules. Directors of mutuals currently owe fiduciary duties to members, imposing similar requirements to general duties. However, the content of those duties is far from clear, making them more difficult for directors to follow and members or a liquidator to enforce. As part of the Ministry's review of the FSCU Act discussed above, Cabinet agreed in principle to impose general duties on directors similar to those that apply to company directors, and provisions allowing directors to rely on third party advice where reasonable.

Enforcement of Directors' Duties

55. Similarly, none of the Mutuals Legislation sets out clear, binding methods for members to hold directors liable for breaching their duties as directors. All of the Mutuals Legislation, except the MI Act, allows the rules of the mutual to set out how disputes between members and the mutual, and in some cases directors and other officers, may be determined. The BS Act expressly allows building societies' rules to provide for arbitration of disputes.

56. The Companies Act on the other hand enables the company to take legal action against directors for breaches of these duties, and obtain injunctions or compensation for breaches of them. The different approach under the Mutuals Legislation may reflect the co-operative nature of mutual financial institutions. There is no evidence that this approach is any less effective in protecting the rights of members as the approach under the Companies Act, but if the duties of directors are expanded, the scope of the dispute resolution provisions may need to be expanded as well.

57. The Companies Act also restricts the extent to which companies can indemnify or arrange insurance for breaches by their directors of these duties (section 162). Generally, a company may not indemnify its directors for their liability to the company, but may arrange insurance (except for criminal liability) if the cost of it is fair to the company. This ensures they remain personally accountable to the company for performing their legal duties. No such restrictions on indemnities or insurance apply to mutual financial institutions.

Appointment and Removal of Directors

58. Finally, only the MI Act contains provisions empowering members to appoint and remove directors. The other Mutuals Legislation requires that the manner of their appointment and removal be set out in the mutual financial institution's rules. The Ministry understands, however, that these rules typically provide for members to appoint and remove directors by ordinary resolution, similar to the equivalent provisions in the Companies Act.

2.6.2.5 Lack of Provisions Ensuring the Equitable Conduct of Member Meetings

59. Good corporate governance requires that meetings of members must be conducted in a manner which encourages member participation and voting, in order for members to carry out their monitoring role effectively, and hold directors to account.

60. The legal requirements on mutual financial institutions for the conduct of members' meetings are very limited, particularly in comparison to the Companies Act. Currently, only building societies and mutual insurers are required to give notice to all members of a general meeting. The rules for friendly societies and credit unions must set out how notice of meetings may be given.

61. There are no requirements in the Mutuals Legislation equivalent to the Companies Act requirements allowing shareholders rights to discuss the management of the company at a general meeting or to propose resolutions, allowing auditors to attend and speak at general meetings, and requiring notice of any meeting to be given to the auditors.

Appointment of Proxies

62. Finally, only the MI Act and BS Act allow members to appoint proxies. For other mutual financial institutions, the right to vote by proxy will depend on their rules. None of the Mutuals Legislation provides for postal votes, although this may be allowed by the mutual financial institution's rules, if it has any. The OECD Principles provide that shareholders "should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia". This is reflected in the Companies Act, which allows proxy and, subject to the company's constitution, postal voting.

2.6.2.6 Differing Requirements for the Appointment and Role of Auditors

63. Mutual insurers must comply with the provisions of the Companies Act relating to auditors. The other Mutuals Legislation contain different requirements on the qualifications an auditor must have, and which related parties may not be auditors. Members appoint the auditors of mutual insurers and building societies. For the other mutual financial institutions, there is no statutory power for members to appoint or replace an auditor.

64. Under the Companies Act, auditors are appointed by directors, but may be replaced by an ordinary resolution of shareholders. If appointed by shareholders, an auditor's remuneration must be approved by them also. Auditors must report to shareholders. The Financial Reporting Act sets out in more detail what the auditors report must contain. Auditors must hold certain qualifications, and may not be a specified related party. More generally, an auditor must ensure that his or her judgment is not impaired by any relationship or interest in the company or any of its subsidiaries. Auditors also have rights to access company information.

65. It seems inconsistent that these provisions already apply to mutual insurers, but not to other mutual financial institutions.

Questions for Submission

1. Do you agree with the problems identified on the governance requirements for mutual financial institutions? If not, please provide your views on this issue.

2. Are there additional weaknesses in the governance requirements for mutual financial institutions?

2.7 OPTIONS

66. This section discusses options for base level corporate governance requirements for mutual financial institutions. Given the variations in the existing corporate governance requirements across different mutual financial institutions, it considers the possible application of a general set of requirements, even though some of the Mutuals Legislation may already provide for these matters or go further. The issue of how to deal with these differing requirements is discussed in the next section.

2.7.1 Option 1: Retain the Status Quo

67. One option is to retain the status quo. While mutual financial institutions are subject to weaker governance requirements than those applying to companies, there is an argument that this is justified on the basis that, unlike companies, mutual financial institutions are generally owned by their customers, and their management is made up of members. As a result, it is argued that the members take a close interest in the affairs of the mutual association, and management has a strong incentive to act in the interests of members.

68. These arguments provide some basis for retaining the status quo but do not take into account the proposed policy changes that may result from the changes to the FSCU Act and the proposed new prudential regime to apply to NBDTIs. It also fails to meet the objectives that have been identified.

69. Further, they do not take into account that mutual financial institutions are becoming progressively larger, and that it is likely that at some stage, the corporate governance requirements will need to be aligned with similarly large counterparts to mutuals.

2.7.2 Option 2: Set Base-level requirements

70. Option two involves setting base-level requirements similar to the corporate governance requirements under the Companies Act. In some areas, the Myners Review and the OECD Principles provide for stricter requirements than the Companies Act. In these areas, however, the Ministry does not see any reason for imposing the stricter requirement. The proposed requirements under this option, under four headings, are:

2.7.2.1 The Rights of Members

71. In this area, the following base level requirements would apply.

Participation and Voting at General Meetings

a. Each member may attend all general meetings of the mutual financial institution.

b. At those meetings each member must have one vote, unless the rules of the mutual financial institution or the mutual's constituting legislation specifies otherwise. The rules may not restrict the right to voting on the basis of age, except for those under 18 years of age.

Election and Removal of Directors

a. Unless the rules of the mutual financial institution specify otherwise, directors must be appointed by an ordinary resolution of members (and, if relevant, voting shareholders), and may be removed by an ordinary resolution of members. An ordinary resolution is one passed by 50 percent of the members entitled to vote and voting on the issue.

Member Participation in Fundamental Corporate Changes

a. The rules of a mutual financial institution, if any, may only be amended by a special resolution of members. Any change which affects the rights of members differently should be subject to the separate approval of members who are negatively affected.

b. Major transactions must be approved by a special resolution of members. A major transaction has a value of 50 percent or more of the gross assets of the mutual.

c. A special resolution is one passed by 75 percent of the members entitled to vote and voting on the issue.

Equitable Conduct of Member Meetings

a. Minimum content and distribution requirements for notices of general meetings.

   i. Written notice of the time and place of any general meetings must be sent to each member, at least 10 working days in advance. The notice must:

      - set out the business of the meeting and any resolutions to be voted on at the meeting;

      - contain such information as a member might reasonably require to form a reasoned judgement in relation to them.

      - minutes must be kept of all shareholders meetings, and copies kept of all resolutions. Members may obtain copies of these on request.

   ii. Rights to question the board and auditors, place items on the agenda and to propose resolutions at general meetings, meaning:

      - members of mutual financial associations should have the same rights to discuss the management of the company at a general meeting of members, and propose resolutions for consideration by the members, as shareholders of companies have under sections 109 and 207, and clause 9 of Schedule 1, of the Companies Act.

      - auditors of mutual financial institutions must be given notice of, and be entitled to attend and speak at, general meetings.

   iii. Rights to vote by proxy and post, meaning:

      - members may appoint proxies to attend and vote at general meetings, or, subject to the mutual financial institution's rules, cast votes by post.

Disclosure of the Remuneration of Directors and Executives

a. A mutual's board must only authorise remuneration for directors it considers, on reasonable grounds, is fair.

b. Directors' remuneration should be disclosed in the mutual's annual report.

c. The number of executives earning more than $100,000 should be disclosed, in bands, of $10,000.

Comment: Requirements to disclose executive remuneration are sometimes objected to because they raise privacy concerns. However, given that the requirements proposed under this heading mirror those under the Companies Act, the Ministry does not consider that this should be a concern.

Question for Submission

3. Do you agree that we have identified appropriate base level requirements that should be introduced to strengthen members' rights in mutual financial institutions? If not, which ones do you not think should be introduced and why not? Are there any additional requirements that should be added?

2.7.2.2 Disclosure and Transparency

72. Under this heading, the following base level requirements would apply.

Content and Distribution of Annual Report

a. Mutual financial institutions should distribute an annual report to all members at least 20 working days before the annual general meeting, or, a notice containing a statement:

- that the members have a right to receive from the mutual, free of charge and on request, a copy of the annual report.
- that the members may obtain the annual report by electronic means and how they may obtain it.
- as to whether the board has prepared a summary version of the annual report[1].

At a minimum, the annual report must contain:

i. Financial statements which comply with the Financial Reporting Act 1993, or summaries of them which present a true and fair view;

ii. The information on directors' and executives remuneration discussed in paragraph above;

iii. New disclosures of interests by directors; and

iv. As is the case for companies, information about donations, names of directors, audit fees, and other fees paid to the auditor for non-audit work.

The annual report must be signed by two directors.

Appointment, Rights and Duties of an Auditor

a. The provisions in the Companies Act relating to the appointment, rights and duties of auditors should apply to all mutual financial institutions.

[1] Similar proposals in relation to the dissemination of information for companies under the Companies Act 1993 are contained in the Business Law Reform Bill 2006 which is currently before Parliament.

Disclosure by Directors Interested in Transactions with the Mutual

a. Directors must disclose any interest they or a related party may have in a transaction involving the mutual financial institutions, unless it is in the ordinary course of the mutual's business. Any disclosures should be made available to members.

b. Directors should be able to vote on any such transaction, unless the mutual's rules or constituting legislation prohibits it. If directors are allowed to vote, the transaction may be voided within three months of disclosure to members if it is unfair.

c. Clear rules for dealing with directors' interests should apply to all mutual financial institutions.

Comment: Under the Companies Act, interested directors may vote on the transaction unless the constitution provides otherwise. However, if the transaction is not fair, it may be voided within three months of disclosure to all shareholders. Mutual financial institutions should be able to take advantage of this exception too, unless their rules or constituting legislation provide otherwise (which the MI Act does). The exception in the Companies Act for transactions with directors in the ordinary course of business would also be carried over, subject to any proposals in the prudential regulation regime (the WCCU Principles, for example, prohibit directors from voting on loans to themselves or related parties, even if they are in the ordinary course of business).

Question for Submission

4. Do you agree that the identified base level requirements should be introduced to improve disclosure and transparency of mutual financial institutions? If not, which one/s do you not agree with, and why not? Are there any additional requirements that should be added?

2.7.2.3 The Role and Responsibilities of the Board

73. Under this heading, the following base level requirements would apply:

Role of Board

a. Each mutual must have a board of directors (which may also be known as a committee of management). Subject to the rules of the mutual, the business and affairs of the mutual must be managed by, or under the direction or supervision, of the board.

b. To this end, directors must have rights to access the mutual's records.

Comment: The OECD Principles provide that in order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information. Under the Companies Act, directors are entitled to inspect their company's records in connection with their duties (section 191). Although there does not appear to be any evidence that directors of mutuals do not enjoy the same level of access, given the legal duties that would be imposed on them under this option, directors of mutuals should be given similar rights.

General Directors' Duties and Remedies for Breaches of them

a. Directors of mutual financial institutions should owe the same general duties to the mutual and its members as directors owe to companies and their shareholders, and have the same ability to rely on third party advice.

b. The mutual itself or a member of the mutual may take legal action against directors to enforce these duties, including injunctions and compensation. The rules of the mutual may specify alternative forms of obtaining redress against directors, such as arbitration, as long as they are binding.

c. Indemnities and insurance for breaches of these duties should be restricted, as they are under the Companies Act.

Remedies for Breaches of Duties

a. The existing alternative dispute resolution mechanisms in the Mutuals Legislation should be extended to cover breaches by directors' of their duties, as long as the mechanisms are binding.

b. Directors' duties should be owed to, and enforceable by, the mutual itself (or in the case of unincorporated friendly societies and credit unions, members as a whole) however individual members may take actions, including on behalf of the mutual or representative actions on behalf of other members. Similar restrictions on indemnities and insurance to those on companies should apply to mutual financial institutions.

Comment: Friendly societies and credit unions are unincorporated, so it might be unclear who the directors' duties are owed to and are enforceable by. Any remedial provisions will need to ensure that members will be able to take individual actions, or with the leave of the court, members may take action on behalf of the mutual (derivative actions) and on behalf of members with the same, or significantly the same, interest in the matter (representative actions). This would reflect the general position under the Companies Act.

Qualifications of Directors

a. Similar statutory qualifications for directors (or the committee of management) of mutual financial institutions to those that apply under the Companies Act should be adopted, particularly in respect of minors and undischarged bankrupts not being directors, and the court should have the power to order that a person may be prohibited from being a director. One difference with the Companies Act would be that a "fit and proper" requirement would not immediately apply.

Comment: The Financial Action Task Force's review of New Zealand's money laundering requirements recommended that "fit and proper" requirements be introduced for NBDTIs, which would include mutual financial institutions. It may also be part of the prudential regulation regime for NBDTIs.

74. A variation on option 2 would be to adopt less stringent base level requirements in some areas on the basis that members of mutual financial institutions take a close interest in the affairs of the association, and management has a strong incentive to act in the interests of members. This, arguably, justifies less stringent governance requirements. These requirements could include requiring directors to comply only with duties to act in good faith in the best interests of the mutual.

Question for Submission

5. Do you agree that the identified base level requirements on the roles and responsibilities of the board should be introduced to enhance the accountability and effectiveness of the boards of mutual financial institutions? If not, which ones do you not agree with, and why not? Are there any additional requirements that should be added?

2.7.3 Option 3: Adopt Base-level Requirements as Principles

75. This option involves adopting the base-level requirements described in option 2 as principles, rather than legal requirements.

76. Under this approach, mutual financial institutions would not need to comply with the base-level requirements. Instead, they would disclose annually the extent to which the base-level requirements have been adopted in their governing rules. They would also be required to disclose the extent to which they comply with their principles to prospective new members. For mutual insurers, given that there are no general rules, the existing Act would continue to apply.

77. This option provides information to members and prospective members on the corporate governance frameworks for mutual financial institutions, and relies upon members creating pressure on management to adopt good governance practices.

2.7.4 Costs and Benefits

78. This section discusses the costs and benefits of the above options.

2.7.4.1 Costs of Different Options

79. In comparison to options 1 and 3, option 2 is likely to result in higher costs to mutual financial institutions. As discussed above, this may arguably be contrary to the current nature of such institutions to provide for members in accordance with the institution's purpose at a relatively lower cost to members than other financial institutions.

80. Option 3 is also likely to result in more administrative costs than option 1, but not to the same extent as option 2 because it allows mutual financial institutions to choose lesser corporate governance requirements. However, in practice, most mutual financial institutions are likely, over time, to adopt the full corporate governance principles, as these become recognised as the appropriate standard for governance of mutual financial institutions.

81. Options 2 and 3 may also create greater costs for mutual financial institutions in having to pay higher remuneration to directors and management. This may result both from the more stringent legal duties that apply to directors and management, justifying higher compensation, and the possible need for better qualified directors and managers with the skills and experience to deliver higher standards of corporate governance.

82. However, the extent of these costs may be limited as some mutual financial institutions already appear to follow the corporate governance requirements that apply to companies. The costs of option 2 and option 3 may also not be significant because the additional director duties imposed are similar to the fiduciary duties already owed by directors to the members of mutual financial institutions, and which will apply to friendly societies and credit unions as a result of the proposal to allow corporatisation.

2.7.4.2 Benefits of Different Options

83. The increased accountability required of management under option 2 should encourage better governance behaviour which decreases the risk of business failure and should help increase the overall efficiency of mutuals. Both of these could create significant benefits. Allowing members to have increased input in decision making should also help ensure that members' interests are being met by management.

84. However, the extent of these benefits is unclear, particularly as there have, in the past, been some problems of mismanagement but not recently. While this is acknowledged, the consequences of failure of a mutual financial institution could be severe, especially for customers and members.

85. It could also be argued that the current less stringent corporate governance regime enables mutual financial institutions to provide services at a lower cost, meeting the needs of many of their members consistent with the purposes for which these kinds of entities were created.

86. While the weaker governance requirements for mutual financial institutions may mean they can provide services at a lower cost to their members, they arguably result in greater risk to their members. It could be argued that this is a trade-off their members are willing to make. It is unlikely however that many of the members of mutual financial institutions are aware that they take on this risk.

87. It may also be argued that there is no benefit from requiring mutual financial institutions to comply with corporate governance requirements similar to those in the Companies Act because they have already voluntarily adopted them. While this is acknowledged, there still remains a concern that other mutual financial institutions have not adopted these requirements, and are not legally required to do so. Adopting a base set of corporate governance requirements means that all mutual financial institutions will be required to meet the same corporate governance requirements. This provides greater assurance to members, customers and others that all mutual financial institutions are properly governed and managed.

88. The Companies Act requirements are generally well understood and more easily identifiable than the fiduciary obligations currently owed by directors and managers of mutual financial institutions. The imposition of duties on directors of mutual financial institutions, akin to those under the Companies Act, may actually simplify enforcement duties. This is an additional benefit that may accrue under option 2, and also option 3.

89. Many of the benefits identified above would be achieved under option 3. However, as compliance with the principles would not be compulsory, there are likely to be some mutual financial institutions that will not meet them, meaning that the benefits are likely to be less. Adopting these requirements as principles would also be confusing for members. Members of mutual financial institutions would also not be afforded a consistent level of protection.

90. The governance requirements suggested in options 2 and 3 are also likely to complement the prudential regulation regime being developed for NBDTIs (although the base level requirements may need to be amended once the details of the prudential regime are known). The new regime is likely to be similar to the prudential regulation regime that applies to banks. That regime relies on various base level governance requirements that apply to companies under the Companies Act.

91. Further, as discussed above, stronger corporate governance requirements may be required, in respect of credit unions, as a result of the proposal to relax the common bond requirements and the proposal to allow credit unions to incorporate.

Questions for Submission

6. Do you agree that the identified base level governance requirements for all mutual financial institutions should be adopted as legal requirements rather than as principles?

7. Do you agree with the costs and benefits that have been identified for the options? If not, please provide your views.

2.8 CONSOLIDATION OF GOVERNANCE REQUIREMENTS FOR MUTUAL FINANCIAL INSTITUTIONS

92. This section discusses the issue of whether the base corporate governance requirements should be specified in the individual statute that applies to each kind of mutual or in a single Act. It is based on the assumption that new base level requirements will apply.

93. Further, the Mutuals Legislation contains a number of varying governance requirements. Many of these requirements are weaker than the governance requirements of companies. A few are stricter, and others are simply different. This section also considers how this variation in governance requirements could be dealt with.

2.8.1 Outcome Sought

94. To obtain a consistent set of governance requirements for mutual financial institutions.

2.8.2 Problems Identified

2.8.2.1 Lack of a Consistent Set of Governance Requirements

95. There is currently no consistent legally enforceable set of governance requirements for mutual financial institutions. Mutual financial institutions are governed by separate Acts which appear to have very few common governance requirements.

96. The MI Act has more detailed corporate governance requirements than the other Mutuals Legislation. However, there are stricter requirements for some mutual financial institutions in comparison with others and in some cases, in comparison with the requirements for companies. For example, the MI Act prohibits directors from voting on a contract they are interested in, whereas the base level requirements would permit this, but provide for the contract to be voidable if it is unfair.

2.8.3 Options

97. There do not appear to be any specific characteristics of mutual financial institutions which would justify imposing different corporate governance requirements on one type of mutual financial institution but not another. Accordingly, the Ministry considers that the base level corporate governance requirements should be specified in a single Act. A number of ways to deal with the inconsistencies between the base level requirements and the provisions on the Mutuals Legislation have been considered.

2.8.3.1 Option 1: A General Governance Act with General Provisions in Each Mutuals Legislation Dealing with Inconsistencies

98. This option involves setting out all the base level requirements in a single piece of legislation, leaving the existing requirements in each of the Mutuals Legislation but amending each Mutuals Legislation to provide that where the relevant provision in the Mutuals Legislation is inconsistent with the base level requirement, the stricter provision (whether in the general governance Act or the Mutuals Legislation) will apply.

99. This option would ensure that if the stricter provision in the Mutuals Legislation was required to be maintained for any reason, it would continue to apply.

2.8.3.2 Option 2: A General Governance Act with the Inconsistencies Identified in Each Mutuals Legislation

100. This option also involves setting out all the base level requirements in a single piece of legislation and leaving the existing requirements in each of the Mutuals Legislation, but would require the Ministry to identify all the provisions which differ from the base level requirements. Where the Mutuals Legislation's provision is weaker, it would be amended to provide that the weaker provision does not apply to financial mutuals. Any stricter corporate governance provisions in the Mutuals Legislation would continue to apply, and compliance with them would count toward compliance with the base level governance requirement.

2.8.3.3 Option 3: A Single Governance Act Containing all Corporate Governance Requirements

101. Under this option all the base level requirements for mutual financial institutions would be consolidated in new legislation containing all corporate governance requirements. This differs from options 1 and 2 in that the Mutuals Legislation would no longer contain any corporate governance requirements for mutual financial institutions. To the extent that some mutual institutions do not provide financial services (e.g. some industrial and provident societies and some friendly societies), governance requirements would remain in the Mutuals Legislation, but would be expressly excluded from applying to institutions that provide financial services.

2.8.4 Costs and Benefits

2.8.4.1 Costs of the Options

102. Option 2 involves identifying in statute the stricter corporate governance requirements in the Mutuals Legislation. It may be difficult to ascertain whether a corporate governance requirement is stricter than the base level requirements. Going through each Act and identifying the stricter requirements will involve a substantial amount of time and effort. The costs of doing this may be substantial.

103. Option 3 simply replaces all the corporate governance requirements in the Mutuals Legislation so is unlikely to be as difficult an exercise. However, under this option, some parts of the Mutuals Legislation may have to be amended in order to make the Mutuals Legislation consistent with the new consolidated legislation and seamless within the Mutuals Legislation itself. While option 1 does not require this at the outset, where an inconsistency arises, a decision would need to be made about which base level requirement is stricter. This could be a difficult decision to make, and creates considerable uncertainty for directors, management, members and ultimately the courts. These costs would be avoided under options 2 and 3.

104. Under option 3, none of the existing stricter corporate governance requirements in the Mutuals Legislation will apply to mutual financial institutions. This means in these areas, that directors and management of mutual financial institutions would no longer need to comply with the stricter requirements, possibly leading to poorer corporate governance in those areas. There would also be an inconsistency between the corporate governance requirements on mutual institutions that provide financial services and those that do not.

2.8.4.2 Benefits of the Options

105. Option 3 will provide the most certainty to those applying the corporate governance requirements.

106. It is also likely to be simpler to deal with any changes that are made in the future to the base level corporate governance requirements. With option 1 or 2, each Act may need to be amended. With option 3 however, consistency of corporate governance principles applying to mutual financial institutions can be maintained fairly easily by amending the consolidated legislation.

107. On the other hand, both options 1 and 2 have the benefit of continuing the existing stricter requirements in the Mutuals Legislation. However, the extent to which these stricter requirements are necessary is not clear.

2.8.5 Transitional Arrangements

108. A key issue with adopting a new set of base level set of governance requirements for mutuals financial institutions is how organisations should be transitioned into the new regime. Any arrangements will need to be carefully thought through to ensure the smoothest transition possible, taking into account the varying upskilling of capacities of different mutual financial institutions and providing sufficient time for organisations that are not currently required to meet these requirements.

Questions for Submission

8. Do you agree with the costs and benefits that have been identified for the options for consolidating governance requirements for mutual financial institutions? If not, please provide your views?

9. Do you have any views on how best the transitional arrangements could be handled?

2.9 ADDITIONAL GOVERNANCE PRINCIPLES

109. The need for corporate governance requirements to be imposed in a legally enforceable manner has been discussed above. The options discussed in section 2.8 all contemplate base level requirements being passed by statute.

110. This section discusses whether additional corporate governance principles may be useful to enhance the corporate governance framework applying to mutual financial institutions.

2.9.1 Outcome Sought

111. To determine whether there is a need for corporate governance principles to ensure good governance of mutual financial institutions.

2.9.2 Current Regulatory Regime

2.9.2.1 Principles Applicable to Mutual Financial Institutions

112. The Financial Reporting Act also applies to those mutual financial institutions that are issuers. These requirements are relevant to the disclosure and transparency base level requirements mentioned above.

113. The OECD principles can be used as a guide for mutuals but are not legally enforceable and there is no evidence that mutuals take them into account.

114. The Securities Commission's Principles can also be used as a guide although they are not legally enforceable and do not apply to all mutual financial institutions.

115. The World Council of Credit Union Inc's Principles of Credit Union Governance are applicable to credit unions and are also not legally enforceable, but do not contain as much detail as the OECD principles or the Securities Commission Principles.

2.9.3 Problems Identified

2.9.3.1 Each Set of Principles Specifically Applicable to Mutual Financial Institutions

116. Financial service providers that are companies are subject to the Companies Act and are also encouraged to adhere to the Securities Commission's Principles.

117. Financial service providers that are not companies but mutual financial institutions are not subject to the Companies Act but are subject to the statutes that regulate them. While the Securities Commission's Principles are applicable, they assume that the corporate governance requirements of the Companies Act apply to the entity in question. This is obviously not currently the case for mutual financial institutions.

118. It therefore seems that while there are some corporate governance principles that may apply to particular mutual financial institutions, there is no common set of corporate governance principles specifically applying to mutual financial institutions that may be used as guidance.

2.9.4 Options

2.9.4.1 Option 1: Using the Securities Commission Principles for Assistance

119. The Securities Commission Principles state specifically that "The Principles can be generally applied to the governance of entities that have economic impact in New Zealand or are accountable in various away to the public". The principles are applicable to all mutual financial institutions except mutual insurers. They may nevertheless assist all mutual financial institutions seeking guidance on governance best practice.

2.9.4.2 Option 2: Preparation of an Annotated Version of the Securities Commission Principles

120. The Securities Commission or another industry body could prepare an annotated version of the principles, making such changes or comments as may be considered necessary to take into account any differences between mutuals and companies. AMI and AFS, at Myners' recommendation, produced an annotated version of the U.K. Financial Services Authority's Combined Code on Corporate Governance for listed companies.

121. A number of suggestions in the AMI/AFS guidance could be included in these principles. For example, the AMI/AFS guidance requires that the notice of meeting should:

a. Explain in reasonable detail the member's voting rights, and how he or she may cast them on any particular issue; and

b. Include the board's recommendation in relation to any issue to be considered at the meeting, with reasons, or if the board is unable to make a recommendation, the reasons why.

122. This additional information is to help overcome barriers Myners identified to members exercising voting rights in mutuals. Myners considered these arose because, membership rights in mutuals are generally widely dispersed, with no individual or group able (or indeed with the motive) to build up a controlling position.

123. Mutual financial institutions could provide that additional information with little difficulty. This may be quite beneficial as the member voting rights in some mutuals can be more complicated than is ordinarily the case for companies.

124. A wider prohibition against "unreasonable" restrictions on the entitlement to participate in meetings and vote at them could also be included in the principles.

125. The AMI/AFS Guidance also provides that new members should be provided with information about their rights and obligations as members. This seems to reflect that the terms of membership of life mutuals in particular are likely to vary more, be disproportionate to members' investments, and so less well understood, than share rights. This could usefully be part of any corporate governance principles for mutuals.

2.9.5 Costs and Benefits

126. Option 1 is the least costly of the options. The Security Commission Principles specifically state that the principles do not apply entirely to all entities and arguably, there is no reason why a mutual financial institution could not use these principles as a guide.

127. Option 1 may be a preferred option as corporate governance principles are typically not enforceable. Essentially, they set out what will make it more likely that a board or directors will comply with the applicable legally enforceable governance requirements. Given this, it may be adequate for mutual financial institutions to use the Security Commission's Principles as a guide.

128. However, while it would be more costly to implement, option 2 may have greater practical effect. Principles specifically applicable to mutual financial institutions would be more likely to be adhered to and more relevant to mutuals on a day-to-day basis.

Questions for Submission

10. Do you agree that corporate governance principles should be applied to mutual financial institutions in addition to the base level requirements that will be imposed as legally enforceable requirements?

11. If so, do you agree that the Securities Commission Principles are appropriate, or would it be better for a revised version to be prepared for mutuals? If the latter, what are the differences that make this necessary?

3. SUMMARY OF QUESTIONS FOR SUBMISSION

1. Do you agree with the problems identified on the governance requirements for mutual financial institutions? If not, please provide your views on this issue.

2. Are there additional weaknesses in the governance requirements for mutual financial institutions?

3. Do you agree that we have identified the appropriate base level requirements that should be introduced to strengthen members' rights in mutual financial institutions? If not, which ones do you not think should be introduced and why not? Are there any additional requirements that should be added?

4. Do you agree that the identified base level requirements should be introduced to improve disclosure and transparency of mutual financial institutions? If not, which one/s do you not agree with, and why not? Are there any additional requirements that should be added?

5. Do you agree that the identified base level requirements on the roles and responsibilities of the board should be introduced to enhance the accountability and effectiveness of the boards of mutual financial institutions? If not, which ones do you not agree with, and why not? Are there any additional requirements that should be added?

6. Do you agree that the identified base level governance requirements for all mutual financial institutions should be adopted as legal requirements rather than as principles?

7. Do you agree with the costs and benefits that have been identified for the options? If not, please provide your views?

8. Do you agree with the costs and benefits that have been identified for the options for consolidating governance requirements for mutual financial institutions? If not, please provide your views?

9. Do you have any views on how best the transitional arrangements could be handled?

10. Do you agree that corporate governance principles should be applied to mutual financial institutions in addition to the base level requirements that will be imposed as legally enforceable requirements?

11. If so, do you agree that the Securities Commission Principles are appropriate, or would it be better for a revised version to be prepared for mutuals? If the latter, what are the differences that make this necessary?