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Submission on Consultation Paper - Exposure draft regulations on sales incentives under new conduct regime

1 This is a submission by Dentons Kensington Swan on the consultation paper dated 28 September 2022 ('**Consultation Paper**') released by the Ministry of Business, Innovation and Employment ('**MBIE**') titled 'Exposure draft regulations on sales incentives under the new conduct regime'.

2 The draft Financial Markets Conduct (Conduct of Institutions) Amendment Regulations 2022 are referred to as the '**Draft Regulations**' in this submission.

About Dentons Kensington Swan

3 Dentons Kensington Swan is one of New Zealand's premier law firms with a legal team comprising over 100 lawyers acting on government, commercial, and financial markets projects from our offices in Wellington and Auckland. We are part of Dentons, the world's largest law firm, with more than 12,000 lawyers in over 200 locations.

4 We have extensive experience advising a range of banks, insurers, non-bank deposit takers, fund managers, and financial advice providers, all of which will be affected by the proposals set out in the Consultation Paper.

General comments

5 The specific decision that was made by Cabinet in February 2022 was to agree that 'financial institutions and intermediaries will be prohibited from offering sales incentives based on volume or value targets to their employees (except senior managers and executives), agents and intermediaries' ('**Cabinet Decision**').

6 The manner in which businesses reward and incentivise their employees, as a general starting principle, is a commercial decision that businesses should be free to determine, subject only to any specific constraints imposed by the State. As a matter of good regulatory practice, such constraints should go no further than required to achieve the policy intent. They should also be proportionate to the harms identified and certain and predictable.

7 The Cabinet Decision is limited to **sales** incentives based on volume or value **targets**. The term 'incentives' is already widely defined at section 446M of the Financial Markets (Conduct of Institutions) Amendment Act 2022 ('**CoFI Act**'). The Cabinet Decision expressly narrows the concept

by referring to ‘sales’ incentives. This means that not all incentives based on volume or value targets were intended to be prohibited by Cabinet. Instead, only those incentives relating to sales were intended to be prohibited. It was also only volume or value ‘targets’ that were the focus of Cabinet concerns.

8 The narrow focus on sales incentives is a deliberate policy decision and an important feature of the regulatory design. As explained in Treasury’s Regulatory Impact Statement (RIA) on regulatory options, some remuneration structures are fundamental to the sustainability of the financial advice industry in New Zealand. That is, they are necessary in order to retain consumer access to high quality financial advice. The main policy objective, therefore, was to find a design that achieved the right balance between reducing conflicts of interest (which can lead to mis-selling and consumer harm) while ensuring consumers can still access appropriate financial advice and products. Limiting the prohibition to sales incentives, confirmed in the Cabinet Decision, was the recommended approach for getting this balance right.

9 In our view, the Draft Regulations go beyond Cabinet’s intent as recorded in the Cabinet Decision and risk undermining the balance intended to be achieved. To the extent that the Draft Regulations capture incentives other than those relating to sales, or go beyond volume or value targets, the Draft Regulations are inconsistent with the Cabinet Decision. This risks unintended adverse consequences for the industry and consumers, without furthering intended consumer benefits.

10 We have three key concerns with the definition of a ‘prohibited incentive’ in the Draft Regulations:

a The first is the failure to restrict the concept to ‘sales’ incentives as outlined above.

b The second is the added breadth provided by capturing incentives that are only ‘indirectly’ determined or calculated by reference to a target relating to volume or value of the relevant services or products. We note that:

i ‘Sales incentives’ is already sufficiently broad to include soft commissions, given the broad definition of an incentive under the CoFI Act (which includes incentives that are monetary or non-monetary and whether direct or indirect). However, importantly, the reference to ‘sales’ ensures only those incentives connected with sales are captured. Adding a further ‘indirectly’ in the Draft Regulations risks extending the scope of the prohibition beyond what is intended. In addition, the extension to capture indirectly referenced determinations or calculations creates an unreasonable level of uncertainty for businesses.

ii Cabinet has consciously made a decision not to ban commissions or incentives altogether This means that business models that rely upon the receipt of sales incentives from financial institutions are not unlawful. A minimum target for all such businesses will be to remain profitable, requiring a profitability threshold to be passed on a sustainable basis. In that sense, all incentives paid to staff of a business that relies upon commissions paid by financial institutions will be indirectly related to hitting a particular target. Otherwise, the business goes under. The prohibiting of such incentives was clearly not Cabinet’s intention, yet that would be the effect of the Draft Regulations.

c The third key concern we have with the definition of ‘prohibited incentive’ is its extension from targets to include other thresholds. We agree that the concept of a ‘target’ warrants clarification to avoid attempts at technical workarounds and gaming the term. However, simply stating 'other thresholds' is far too broad and goes beyond the Cabinet Decision.

Specific response to the questions raised in the Consultation Paper

Question 1: Do you consider that the draft Regulations give effect to Cabinet's decision to prohibit sales incentives based on volume or value targets? If not, why not?

11 As set out above, the Regulations are broader than the narrower prohibition on sales incentives based on volume or value targets approved by Cabinet. In our view, in order to give proper effect to the Cabinet Decision and ensure that it is properly targeted, the following changes should be made to proposed regulation 237B 'What is a prohibited incentive':

a Delete the words 'and (directly or indirectly)' where they appear after 'by reference'.

b Delete the words 'or other threshold' where they appear after 'to a target'.

c Add 'sold by the person' at the end of regulation 237B after the words 'services or products'.

d Include a definition of 'target' in regulation 237B to clarify that the term includes exceeding a particular threshold level of activity referenced at section 446M(3) of the CoFI Act, or not exceeding predetermined thresholds based on those types of activity. This would be a more effective approach to clarifying what is meant by 'target' without introducing parameters on incentives that are broader than those approved in the Cabinet Decision.

Question 2: Do you have any comments on the examples chosen of a prohibited incentive and a non-prohibited incentive?

12 The examples currently provided in the Draft Regulations are helpful and should be retained.

13 Given the risk of uncertainty, we recommend additional examples of incentives that are not prohibited be included. The existing examples are insurance focused and it appears practices related to insurance sales are the focus of the Draft Regulations (perhaps this also skews the manner in which the Draft Regulations have been developed). Examples should be provided for other business types.

14 In particular, we have a concern that mere recognition and encouragement of an employee's efforts might be regarded as falling within the concept of a 'prohibitive incentive' given the current breadth with which the concept is defined in Regulation 237B. For example, where an employee is recognised for a strong contribution to the success of a business in the form of a company newsletter 'shout out'. We recommend including an example along those lines as an example of activity that is not included within the prohibition. A caveat could be added to such an example that it only holds so long as there is no form of overt incentivisation to hit a particular target of sales to receive a similar recognition. We believe that adding such an example would assist in clarifying the extent of the prohibition for good personnel management practices.

Question 3: Do you have any other comments on the way the draft Regulations define prohibited incentives?

15 A fundamental concern we have with the manner in which the Draft Regulations define 'prohibitive incentives' is the fact that many businesses operate mixed models in their income structures. The Draft Regulations appear overly simplistic (and insurance focused) in the way intermediaries are treated. By way of example, financial advisers within a financial advice provider might generate

income for their employer through a combination of fees for service for an overall financial planning-type activity, together with commissions received from the sale of a range of financial advice products of which some may come from financial institutions and other may come from the likes of KiwiSaver or other fund providers. If all third party provider remuneration received by the financial advice provider employer is aggregated at the financial advice provider level, but then financial advisers are rewarded with bonuses or incentives based upon the overall level of income generated for the business, the arrangement will be in breach of the Draft Regulations. We do not believe this is appropriate, and will give rise for a need to fundamentally restructure legitimate performance reward arrangements. The alternative for financial advice providers in these circumstances would be to cease distributing the problematic financial institution product altogether, which would not be a good customer outcome. Nor would it be a level playing field for financial institutions in relation to other providers.

16 Additionally, we recommend a defined set of exclusions from the prohibition to ensure that non-problematic or desirable incentive arrangements are clearly permitted, and only problematic volume-based incentive arrangements are prohibited:

a First, we recommend the inclusion of an express ability for providers to specify a minimum volume of business that a distribution intermediary must transact in order to retain a business relationship with the provider, or to qualify for particular levels of support. This is a straight matter of commercial common sense. Providers have finite resources, and should be free to devote those resources for the optimal benefit of the provider and the customers it serves. Providers should be entitled to sever relationships with intermediaries where the volume of business renders it uneconomic for the provider to sustain the relationship. Providers should also be able to cease the provision of support to the intermediary if it might preclude the provision of support to another intermediary who is servicing a greater number of the provider’s customers and who is therefore likely to deliver greater benefit for the provider’s customer base.

b Second, there should be an express carve-out to enable financial institutions to specify minimum threshold criteria for an adviser to qualify for training support. This recognises that providers need to manage their resources in cost effective ways. Allowing providers to restrict the training they provide to advisers who meet minimum volumes of business should be tolerated as a valid commercial response to an adviser’s level of engagement with the provider.

c Third, setting threshold levels of business that must be transacted before an adviser can move to a higher level of remuneration structure or seniority in a business should be expressly permitted. Allowing providers to determine the level of business that an individual must transact in order to ‘earn their stripes’ is a simple marker of increased seniority and experience. Excluding such gateways to progression would present significant employment challenges for some organisations. Such measures are commonly employed in determining which advisers should be deployed to assist with more complex customer situations or supervise junior advisers. In our view, ensuring such career progression mechanisms can continue is likely to be beneficial for customer outcomes. Banning them may well be detrimental to providers being able to develop more sophisticated models aimed at enhancing the breadth and quality of advice they are able to provide.

17 For the avoidance of doubt, we support the retention of the current set of defined carve-outs from the proposed prohibition, supplemented by the above.

Question 4: Do you have any comments on the definition of 'relevant person' in relation to a financial institution or an intermediary?

18 Unless the definition of 'prohibited incentive' is narrowed to remove reference to entitlements that are 'indirectly' determined and calculated by reference to a target, as proposed earlier in this submission, we believe the concept of 'relevant person' needs to be narrowed at regulation 237D. This is so it only applies to sales by the person in question, and exclude incentives received higher up the food chain. The example we have in mind is where a licensed financial advice provider received some of its income in the form of commission from a financial institution, and its employee reward structure includes a bonus based on the profitability of the overall organisation.

Question 5: Do you have any comments on the application of the draft Regulations to senior managers and executives?

19 We agree with the approach taken in the Draft Regulations when it comes to the exclusion of senior mangers and executives. To the extent that those senior managers or executives are 'involved' in a sales activity, it is appropriate that they should be captured by any regulatory prohibition to the same extent as frontline staff.

Question 6: Do you have any other additional comments on the Exposure Draft Regulations?

20 In our view, the risk of unintended consequences flowing from the Draft Regulations in their current form is very real. The relatively simplistic approach taken with the drafting, coupled with the overly broad capture of 'prohibited incentives' carries a high risk of causing undue commercial uncertainty as to what may or may not be permitted. This may result in some intermediaries restricting the services and products provided to their clients to exclude those issued or offered by financial institutions. This is particularly an issue in relation to debt securities issued by registered banks, with intermediaries having a strong regulatory disincentive to expose themselves to the complication of debt securities issued by registered banks and licensed non-bank deposit takers, when compared with other issuers of debt securities. We believe this is an undesirable outcome, and cannot have been Cabinet's intent. A simple solution to this concern would be to exclude intermediated debt security issues by banks and non-bank deposit takers from the scope of the prohibition.

Further information

21 We are happy to discuss any aspect of our feedback on the Consultation Paper.

22 Thank you for the opportunity to submit.

Yours faithfully

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