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Exposure draft regulations on sales incentives under new conduct regime

This submission on the Exposure draft regulations on sales incentives under new conduct regime, 28 September 2022 (the Consultation Paper), is from the Financial Services Council of New Zealand Incorporated (FSC).

As the voice of the sector, the FSC is a non-profit member organisation with a vision to grow the financial confidence and wellbeing of New Zealanders. FSC members commit to delivering strong consumer outcomes from a professional and sustainable financial services sector. Our 106 members manage funds of more than $95bn and pay out claims of $2.8bn per year (life and health insurance). Members include the major insurers in life, health, disability and income insurance, fund managers, KiwiSaver, and workplace savings schemes (including restricted schemes), professional service providers, and technology providers to the financial services sector.

Our submission has been developed through consultation with FSC members and represents the views of our members and our industry. We acknowledge the time and input of our members in contributing to this submission.

The FSC's guiding vision is to grow the financial confidence and wellbeing of New Zealanders and we strongly support initiatives that align with our strategic intent and deliver:

- strong and sustainable customer outcomes
- sustainability of the financial services sector
- increasing professionalism and trust of the industry.

We welcome the opportunity to comment on the exposure draft of the Financial Markets Conduct (Conduct of Institutions) Amendment Regulations 2022 (the Draft Regulations) relating to the prohibition of sales incentives based on volume and value targets. Our members have some concerns on the current drafting of the Draft Regulations, as set out in this submission, and we encourage their further consideration.

There are a number of examples of incentives that would be prohibited under the Draft Regulations which are unlikely to drive behaviours adversely affecting consumers' interests, rather, they help to drive sustainable productivity within financial institution (FI) businesses. The Draft Regulations as they stand, may have the unintended consequence of removing incentives that lead to better customer outcomes such as further adviser or distributor training.

We strongly disagree with the proposed position not to specifically exclude senior managers and executives from the prohibition, and we have concerns that this creates uncertain regulations that are open to interpretation. We encourage further clarity within the final regulations, setting out this exclusion

to align with Cabinet's prior decision. We suggest that this can be achieved by including specific drafting in the definition of "relevant person" in the final regulations.

We welcome continued discussions and engagement to ensure the regulations for the conduct regime are clear and unambiguous in order avoid unintended consequences and inconsistent application.

I can be contacted on 021 0233 5414 or richard.klipin@fsc.org.nz or Carissa Perano, Head of Regulatory Affairs, at carissa.perano@fsc.org.nz, to discuss any element of our submission.

Yours sincerely

Richard Klipin
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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?

Our members consider that the Draft Regulations do give effect to the prohibition on sales incentives however there are concerns that the current drafting may be interpreted more broadly than the policy decisions previously made by Cabinet, leaving uncertainty as to how the prohibition is applied. We consider there to be areas that require clarification to ensure that the regulations give effect to Cabinet's decision and have provided further details on the areas of uncertainty in this submission.

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

Our members support the inclusion of examples in the Draft Regulations as they are clear, useful and show a clear differential between linear and prohibited incentives. However, we have some concerns about the simplistic nature of the examples given the huge variety of remuneration structures that exist within FIs and between FIs and their agents and intermediaries. It would be beneficial if further examples are provided to include the types of incentives which are less clear, in order to provide clarity about how the prohibition is applied.

We also suggest that further examples covering more complex incentives, such as supplementary training provided to advisers and companywide incentive programmes which have an overall company financial target would also be useful.

3. Do you have any other comments on the way the draft regulations define prohibited incentives?

Our members have raised concerns that the Draft Regulations could result in unintended consequences. We are concerned that the wide definition of incentives could extend to incentives which drive good customer outcomes, such as training for advisers and distributors. These kinds of incentives are not the intended target of the regulations, and we have concerns that if FIs have to offer these kinds of incentives to everyone without being able to apply some sort of metric gateway (which has typically been a sales or volume metric) that offering this kind of incentive would be unaffordable for FIs. The resulting unintended consequence would be that FIs would have to cease offering supplementary training to certain groups which would be detrimental to customer outcomes.

One of the goals of the Financial Services Legislation Amendment Act 2019 was to improve access to high quality financial advice. Whilst we agree it can lead to poor customer outcomes when financial advisers are incentivised to sell more product, the next logical motivational tool for a FI is to incentivise financial advisers to provide a financial advice service more often to more clients. The Draft Regulations prohibit FAPs from setting targets around the volume of financial advice, however there are instances of incentives that are not based on sales volumes but are volume related. For example, the Draft Regulations appear to prohibit an insurer from using customer surveys that link the quality of advice to the level of commission paid to financial advisers as an incentive to encourage their customers to provide feedback. Prohibiting such volume related incentives has the potential unintended consequence of a reduced level of financial advice being offered.

We note that the intention of the "incentive" definition set out in section 446M of Financial Markets (Conduct of Institutions) Amendment Act 2022[1] (the Act), is to capture all incentives so that the fair conduct principle applies across all the consumer parts of a FI's business. This recognises that incentives in

[1] Referred to in draft regulation 237B which sets out the definition of a "prohibited incentive".

any part of an organisation can have an impact on conduct. However, the policy decisions which underpin the Draft Regulations are that only sales incentives linked to a volume or value based metric should be caught. As such, the linking of the Draft Regulations to the definition of incentives under the Act may not be appropriate and could result in the regulations applying more broadly than intended where the risk of a conflict of interest at the point of sale is extremely low.

The “prohibited incentive” definition adopts the section 446M definition of “incentive” which (as paragraph 26 of the Consultation Paper observes) adopts the specific “involved” definition in the Act. The “involved” definition applies only in the context of the provision of services or products “to a consumer”, and accordingly incentives arise only in that context (not in the context of provisions of services or products to wholesale clients or other non-consumers). This outcome is appropriate as consumer protection is the primary objective of the Act. It would be desirable, for clarity, that the context where the prohibition applies is made more explicit in the final regulations, rather than requiring tracing through to the legislation to find when the prohibition applies. This clarification could be achieved if the words “provided to a consumer” are added after “relevant services or associated products” in the “prohibited incentive” definition.

We also note section 446M contains the word “indirect”/ “indirectly” in three separate places and Draft Regulation 237B also contains the word “indirectly” which creates a lot of uncertainty as to the scope of the prohibition. It is also very likely to result in the prohibition being applied far wider than what Cabinet had intended. This is particularly the case for senior managers, who Cabinet sought expressly to exclude from the prohibition.

We submit that MBIE should consider the scope of the Draft Regulations and whether it is appropriate to provide a narrower definition of incentives in the regulations than in the Act to limit any unintended consequences. We also suggest further clarity on the reference to “indirectly” in Draft Regulation 237B (such as, whether or not it applies to the number of customer interactions or pipeline measures such as leads and conversion rates).

4. Do you have any comments on the definition of ‘relevant person’ in relation to a financial institution or an intermediary?

We consider it would be more appropriate to expressly exclude senior managers and executives in the definition of ‘relevant person’ as set out in our response to Question 5 below.

5. Do you have any comments on the application of the draft regulations to senior managers and executives?

Our members strongly disagree with MBIE’s decision that no specific reference to senior managers and executives within the regulations is required. Our members are concerned that not including a specific exclusion for senior managers and executives leaves the Draft Regulations uncertain and open for interpretation.

Rather than expressly excluding senior managers and executives, MBIE is proposing to rely on the definitions of ‘relevant person’, ‘incentive’ and ‘involved’. At a high level, the test of whether the

prohibition applies will essentially be whether a senior manager or executive directly or indirectly arranges[2] the contract for service or for the acquisition of a product or gives regulated financial advice.

This leaves many areas of uncertainty as to what is considered "senior", particularly in a large business where there may be many levels of management, most of which are unlikely to drive conflicts of interest at the point of sale.

Given the uncertainty in the Draft Regulations as to whether or not a person is involved in the acquisition of a product, this will likely lead to wide ranging interpretations from FIs. For example, whether a senior insurance underwriter who offers revised terms to a consumer via a financial adviser who is acting on the consumer's behalf would be subject to the prohibition. A further example is a regional manager who works for a fully intermediated life insurer and manages a team of business development consultants who provide support for independent financial advisers who act on behalf of the consumer. Lastly, an executive manager (reporting to the senior leadership team and with no direct reports that are consumer facing) in a large fully intermediated life insurer business (such as those with no sales directly to a consumer) responsible for pricing, distribution, or underwriting.

We also note that whilst the view of officials appears to be that that the current definition of incentives is sufficient to exclude senior managers and executives as discussed above, it will ultimately for the Courts to interpret the definition of "incentives", "involved" and "arranged" in the Act. We consider that in order to give effect to Cabinet's previous decisions in a way which the Courts will be able to apply, the final regulations need to expressly provide for an exclusion for senior managers and executives.

In summary, we submit that the final regulations need to be clear and intended exemptions expressly stated to avoid a range of interpretations by FIs. We consider that an express exclusion would provide clarity and potentially mitigate the possibility of contrary interpretation by the courts to that of MBIE in the future.

6. Do you have any other additional general comments on the exposure draft regulations? For example, do you see any unintended consequences arising from the draft regulations in relation to any other matters? Are there any areas where the application of the draft regulations is unclear and could benefit from additional examples or guidance?

Our members wish to reinforce that MBIE should consider the policy decisions which have already been made regarding the prohibition on sales incentives. Previous decisions have been specific, and the Draft Regulations should reflect these specific decisions. Whilst the Act is principles based legislation, our members consider that as the Draft Regulations are intended to specifically prohibit a certain kind of incentive, wide definitions and interpretations are not helpful. As currently drafted the prohibition may be so far reaching that FIs find it difficult to incentivise staff to drive business productivity, growth and support the long term sustainability of their businesses. This could lead to reductions in the products or services available to customers, as businesses look to remain sustainable.

FIs are still subject to the overarching duty in the Act to design and manage incentives to mitigate or avoid the actual or potential adverse effects of incentives on the interests of consumers. Therefore, it is more appropriate to have a narrower prohibition which still gives effect to Cabinet's decision rather than an unnecessarily wide prohibition which may have unintended consequences on the growth of the financial

[2] Arrange is defined in section 446P as "arrange, in relation to a contract for a service or for the acquisition of a product, *includes* to negotiate, solicit, or procure the contract" (emphasis added).

services industry. We encourage further consideration to ensure the final regulations are clear and unambiguous in order avoid unintended consequences and their inconsistent application by FIs.