SIA | SECURITIES INDUSTRY ASSOCIATION

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Financial Markets Team
Small Business, Commerce and Consumer Policy
Building, Resources and Markets
Ministry of Business, Innovation & Employment
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Tēnā koe Financial Markets Team,

Securities Industry Association submission: Consultation paper – Exposure draft regulations on sales incentives under new conduct regime

Please find attached the submission prepared by the Securities Industry Association (SIA) in response to the Consultation paper – *Exposure draft regulations on sales incentives under new conduct regime (28 September 2022).* We thank you for the opportunity to present our comments on this consultation paper.

About SIA
SIA represents the shared interests of sharebroking, wealth management and investment banking firms that are accredited NZX Market Participants.

SIA members employ more than 500 accredited NZX Advisers, NZDX Advisers and NZX Derivatives Advisers, and more than 400 Financial Advisers nationwide. The combined businesses of our members work with over 300,000 New Zealand retail investors, with total investment assets exceeding $80 billion, including $40 billion held in custodial accounts. Members also work with local and global institutions that invest in New Zealand.

Some SIA member firms may make an individual submission based on issues specific to their firm's business. Those issues and views may not be reflected in this submission. No part of this submission is required to be kept confidential.

Please get in touch should you have any questions about this submission or require further information.

Nāku noa, na

Bridget MacDonald
Executive Director

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Submission on Exposure draft regulations on sales incentives under new conduct regime

Your name and organisation

Name	Bridget MacDonald, Executive Director
Organisation (if applicable)	Securities Industry Association (**SIA**)

Responses to consultation document questions

Prohibited incentives

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?*

Yes, however, the reach of the draft regulations is beyond the remit provided by Cabinet and will likely lead to unintended consequences, particularly for Securities Industry Association (**SIA**) members (i.e. **NZX Market Participants**), who are intermediaries, and therefore captured by applicable intermediary provisions of this legislation, and their respective clients.

By way of background and context for this submission, we note the SIA understands Cabinet made the decision to regulate sales incentives based on volume or value targets following findings in the Financial Markets Authority (**FMA**) and Reserve Bank of New Zealand (**RBNZ**) conduct and culture reviews of banks and life insurers, the FMA thematic review of sales incentives and the Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. The findings were essentially that sales incentives were driving poor conduct in financial institutions.

For completeness, the SIA agrees with these findings and is supportive of regulation to eradicate the types of sales incentives based on volume or value targets that lead to poor outcomes for consumers. However, the SIA is of the opinion that the draft regulations go further than Cabinet intended and, due to the breadth of the draft regulations, is highly likely to have unintended consequences that may have a detrimental impact on the industry and, therefore, the consumer.

The Discussion Document, *Regulations to support the new regime for the conduct of financial institutions (April 2021),* clearly states in paragraph 119 that the purpose of the regulations is not to deal with all types of incentives that could lead to poor outcomes for consumers. The intention is to deal with incentives that are particularly problematic, i.e. sales target based incentives.

As noted below and in further detail in this submission, the proposed drafting will likely have unintended consequences resulting in negative impacts on SIA members and their respective clients, which we do not believe to be the intent of Cabinet.

For example, the current drafting of the regulations appears to be trying to capture all incentives extending the perimeter beyond just "incentive" and "volume or value", which is the terminology used to date. Cabinet's decision was solely to prohibit the offering of 'sales incentives based on volume or value targets'. Yet, the proposed regulations are broadened beyond the intention of the original decision, which could impose a restraint on business

freedom. Cabinet's decisions should be interpreted and applied as intended.

For completeness, we refer to earlier submissions and discussions with respect to NZX Market Participants and the impact of Conduct of Financial Institutions (**CoFI**) legislation on NZX Market Participants as intermediaries. The legislation, in effect, requires each Financial Institution (**FI**) to impose requirements and controls on each intermediary to ensure that the FI meets its regulatory requirements may accordingly require a further level of compliance for each intermediary, which is already highly regulated. This will likely impose significant costs and burdens to intermediaries that may cause either or both the intermediary and FI to limit the availability and distribution of products. This would not be a fair outcome for, or in the interests of, the consumer.

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

The examples chosen reflect and are well aligned with Cabinet's intention with respect to the purpose of the draft regulations.

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

Based on the second example given under regulation 237B, we understand that the definition of "prohibited incentive" is intended to exclude commissions calculated on a "linear basis" as such commissions will not be calculated "by reference to a target or threshold." We note, however, that section 446M(3)(g) provides that determining or calculating a "matter" by reference to the volume or value of the services or products involved includes doing so "on a linear basis". Given that the phrase "matter" is likely to be broad enough to capture a target or threshold, it is possible that these words do not in themselves exclude commissions calculated on a linear basis, as intended. We would suggest, therefore, that the definition explicitly provides that an incentive calculated on a linear basis is not prohibited rather than dealing with this in the example only.

Recipient of incentive

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

The definition of 'relevant person' includes intermediaries involved in the provision of a financial institution's (**FI**s) relevant services or associated products, which will include NZX Market Participants.

We strongly believe that incentives received by an NZX Market Participant from a FI in relation to debt securities issued by the FI should not result in the NZX Market Participant being caught as a 'relevant person'. Accordingly, in circumstances where only volume or value target incentives paid by NZX Market Participant Financial Advice Providers (**FAPs**) to Financial Advisers (**FAs**) that are directly related to FI debt securities sales should result in the recipient adviser being considered as a 'relevant person'.

Exclusion of senior managers and executives from the incentive prohibition	
5	*Do you have any comments on the application of the draft regulations to senior managers and executives?*
	SIA does not believe that the draft regulations properly give effect to Cabinet's policy decision to exclude senior managers and executives from the prohibition. While we recognise that such personnel will not typically be "involved" (as that term is defined in section 446Q(3) of the FMC Act) in the provision of the relevant service or product in any immediate sense, the definition of incentive in section 446M also captures any person who is "indirectly" involved. The phrase "indirectly" creates significant uncertainty for firms as to the degree of involvement required by senior managers and executives – for example, would a chain of reporting lines from those directly involved up to the senior manager or executives be sufficient for them to be indirectly involved or is some other level of involvement required? Given the potential consequences of non-compliance for firms, such uncertainty would potentially have a chilling effect on the use of any sort of target based incentives as a part of reasonable remuneration at a senior level, which is clearly not what Cabinet had intended. As such, we submit that the regulations need to include a bright-line rule excluding senior management and executives from the prohibition.
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?*
	Broadening of remit – prohibited incentives As above, the SIA is concerned with some of the language in the draft regulations and is of the opinion that it seeks to significantly widen the breadth of the remit given by Cabinet. In particular, clarification is sought on regulation 237B 'What is a prohibited incentive', more specifically, what "or the nature or value of the incentive", "indirect" or "other threshold" is intended to capture or refer to. The examples provided clearly fall within the ambit of an incentive that is directly determined by reference to a target, which is the intent of Cabinet's remit, but these additional qualifiers are potentially beyond that remit and examples to limit have not been provided. We also further seek clarification on how MBIE envisages these regulations working. **Secondary market trading should be explicitly excluded** We understand that, quite rightly, the regulations are not intended to apply to any incentive paid by intermediaries in respect of trading in an associated product on secondary markets – this is because no commission will be payable by the relevant FI in respect of such trading. However, given that the definition of intermediary in section 446Q applies to any entity that has received a commission from an FI in respect of an associated product, there is a technical risk that any entity which received a commission from an FI in respect of the primary issue of an associated product is then also automatically treated as an intermediary in respect of its involvement in any subsequent secondary market trading in that product. This would appear to have the unintended effect of preventing that entity from paying any "prohibited incentive" in respect of such trading. To address that risk, we submit that the regulations should expressly provide that any trading on secondary markets is not caught by the relevant prohibitions.

Exclusion should be limited to provision to retail clients

The definitions of relevant service and associated product in section 446F of the FMCA Act mean that any commission payable in respect of the provision of a relevant service or associated product to wholesale investors also appears to be caught by the proposed prohibitions.

While we agree that appropriately crafted prohibitions should apply in respect of any retail customers, we submit that there is no good policy reason for them to apply in respect of wholesale investors who may also have access to the same services or products. Such investors are able to reach their own views as to the suitability of any financial products and to understand and manage any conflicts of interest that may arise from incentive structures in place in respect of those products and, for that reason, do not need to be afforded the same level of regulatory protection as retail customers. Indeed, that policy position is preserved in respect of any wholesale investor-only services or products, which are not within the scope of the regulations. We would suggest, therefore, that the regulations provide that the prohibition does not apply to any commission payable in respect of any supply to wholesale investors.

Other Comments

1. The SIA supports the intention of the regulations to mitigate the perverse outcomes that could arise from sales incentives based on volume or value targets, particularly in bank loans and insurance policies, with the ultimate intention to encourage better outcomes for consumers.
2. As noted above, SIA's members are considered to be intermediaries by definition and therefore captured by this legislation. As intermediaries, NZX Market Participants provide a critical role in the primary market by facilitating the raising of capital through initial public offerings (**IPOs**) and the issuance of bonds. They also play a role in distributing these products, including through the secondary market.

Unintended consequences could lead to disincentives that reduce customer access to financial products

3. The legislation and related regulations may have unintentionally overlooked the complexities of the securities industry and the practical implications when they are applied to capital raising activities and bond issuance, in addition to the broader distribution methods for these products. However, it is likely that the unintended consequences arising when the regulations are applied could negatively impact the companies seeking to raise capital and the consumers seeking opportunities to invest.
4. For example, a scenario could evolve where NZX Markets Participants may be disincentivised to distribute a Financial Institution's (**FI**) products. For example, two new products come on the market: **Bank A** is a financial institution issuing new bonds, and **Company B** is a non-financial institution issuing a bond. NZX Participant **Firm C** has assessed these products for **Customer D's** portfolio and personal circumstances, and they are both equally suitable investment options. As an intermediary, Firm C could recommend either Bank A's or Company B's bonds to Customer D, disclosing the flat fee or commission for transactions. However, Firm C could choose not to distribute Bank A's bonds because of the compliance framework that Bank A requires Firm C to comply with and attest to for the purposes of compliance with the legislation. In this case, Bank A would have a narrower market distribution of its product, and Customer D would have reduced access to viable financial products offered to them. This is not a good scenario for any of the parties, but it illustrates

how the current drafting may result in the unintended consequence of intermediaries limiting distribution of certain otherwise suitable products due to the additional compliance burden, which is not in the customer's interest nor any business raising capital or issuing bonds through a FI.

5. Furthermore, Bank A and Company B could equally be undertaking a capital raise for **Business F**, but depending on which channel Business F chooses, there would be differences in how these products are regulated due to their distribution pathway. Sales incentives restrictions do not apply when Company B, a non-financial institution entity, is undertaking the very same process for a capital raise that Bank A could also undertake. This could also result in the unintended consequence of limiting distribution of products due to the additional compliance burden related to FIs.

   SIA recommends that capital markets products are not captured and subjected to sales incentives regulations when a Financial Institution is the issuer.

Appropriate to exclude to wholesale market

6. The draft regulations appear to capture the wholesale market. However, we do not deem this necessary or appropriate, given the nature of this market segment and the criteria for people or organisations transacting as wholesale or eligible investors. We support the wholesale market from being excluded from this legislation, and suggest the regulations should be amended to reflect this.

Unnecessary complexity from diverse financial products

7. These regulations are potentially creating unnecessary complexity when they seek to single out the incentives for FI products. Some FI products might be mixed into a product package. For example, a financial product that includes shares from a range of listed companies could also contain a small number of bonds from a couple of banks. Therefore, it is difficult to understand how an adviser's transactions would be assessed for performance purposes at year-end, as anything connected to a FI would have to be removed from the incentive calculation. It would be excessive work to work through all transactions and determine which elements came from a FI for each of the firm's advisers. NZX Market Participant Firms may end up with multiple payment structures for staff and/or products, adding unnecessary complexity to financial products and services that are already highly regulated to protect consumer interests.

Appropriate timeframe to implement changes

8. Given the potential impact of legislative and regulatory changes on the sector, SIA suggests that due consideration is given for a fair and reasonable period to be factored into implementing any changes. For example, firms need to review their current circumstances, employment contracts and compliance controls and adjust accordingly. This would be complex and time intensive, and as such, we suggest 12 months is a reasonable timeframe to implement any sales incentive-related changes.

Summary

9. The negative impact of the legislation and regulation on capital markets seems like an unintended consequence when the primary concern has been the conduct of banks and insurance. NZX Market Participants are also regulated through the Financial Services Legislation Amendment Act and Code of Professional Conduct for Financial Advice Services, in addition to the NZX's Participant Rules, which each contain comprehensive rules and sanctions around acting in clients' best interests and managing any conflicts of interests.

10. The unintended consequences of the regulations could result in a chilling effect on the distribution of FI products because they are carved out of product structures in place

of those with a higher remuneration base or are less complex for firms to deal with to meet their obligations.

11. We strongly recommend that NZX Market Participants as intermediaries should be excluded from these regulations due to the nature of their already-regulated product and activity. More specifically, we submit that distributors of the products and the products related directly to capital markets, such as capital raisings and bond issues, should be excluded from these regulations.

12. We thank MBIE for the opportunity to submit on these draft regulations. We welcome the opportunity to discuss our submission further or provide additional information if required.

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