POLISH FINANCIAL SUPERVISION AUTHORITY

Warsaw, 17th July 2013

DRK/WRM/485/55/1/55/2013/PT

President of the Management Board
Brokerage House

Director Brokerage Office
Bank organisational unit that carries out brokerage activities
Branch of a foreign investment firm

Dear Sir/Madam,

In relation to the observed dynamic development of the area of brokerage services which concern derivatives not permitted for organised trading, in particular those dealt in on the Forex market, and having regard to the hitherto conclusions resulting from the ongoing supervision and control activities, the Office of the Polish Financial Supervision Authority (hereinafter the KNF Office) presents the attached Statement (hereinafter the Statement, the Letter).

The Letter to investment firms is a reaction to the observed rapid expansion of investment firms offering of brokerage services on the Forex market. The dynamic interest of investment firms in the development in this segment of the capital market leads to the fact that, in the conditions of strong competition, diverse and intensive forms of advertising and promotion of services and instruments are adopted. New methods of performing appropriateness tests are developed, and a broad range of technological solutions is being implemented often employing third-party service providers.

Based on the analysis of the hitherto conduct of investment firms: both on the external level (i.e. in relations with clients) and the internal level (concerning the technical and organisational conditions and of the brokerage activities performed), the KNF Office decided to use this Statement to draw attention to the nature of investing in Forex instruments , the relevant regulations of the valid law which are of basic importance in this area and their practical meaning. However, it has to be explained that the Statement does not cover all aspects related to the manner and mechanism of offering services on the Forex market. The Letter presents those aspects of the activities, which have been noticed in the course of the supervision and give rise to the KNF Office's concerns.

The KNF Office believes that presentation of market practices related to the functioning of Forex market and the position of the KNF Office (regardless of other actions, such as market education initiatives) is going to be useful and incorporated into daily operations of investment firms. It pertains both to entities providing brokerage services which are active in the Forex market and those that are planning to introduce that type of activity into their offering. At the same time, the KNF Office points out that some of the remarks and observations are of universal nature and will apply to other areas related to trading in financial instruments.

The KNF Office declares that remarks included in the Statement which concern provisions of the Regulation of the Minister of Finance of 24 September 2012 *on determination of the detailed technical and organisational conditions for investment firms, banks, which are referred to in Article 70(2) of the Act, and custodian banks and the conditions of assessing by brokerage houses of*

internal capital, and remarks in point 5 concerning outsourcing of information systems used on Forex market, do not apply to branches of foreign investment firms.

Signed

Chairman
Polish Financial Supervision Authority
Andrzej Jakubiak

Appendix

Statement on the conduct of investment firms on the Forex market

General remarks

An increased scope of activity of investment firms in the area of derivatives not subject to organised trading has been recently observed. The conduct of supervised entities often take form of highly intensified marketing actions aimed at inducing the client to use the service or product. With this aim, various types of inducing prospective clients to invest their funds on the capital market are employed.

These actions may lead to increased interest of investors in that type of activity. It must be remembered, however, that derivatives are *complex financial instruments*, and thus encumbered with *particularly high investment risk*. The inherent risk results from the effect of financial leverage, which allows that even with a small involvement of own initial capital, it is possible to conclude transactions which concern financial instruments of much higher nominal value. As a consequence, it is possible to obtain, at a later time, potentially higher profits. Investments in those types of instruments seem, therefore, for the investor to be a very attractive form of allocating funds. Yet making that type of investments entails at the same time high risk of loss of investor's funds, much more than the level of involved capital when concluding the derivative transaction. In this context, the fact of significant asymmetry between investors who obtained a profit and the investors who incurred a loss from activity on Forex derivative market needs to be kept in mind. As revealed by a study, conducted by the KNF Office from 1 January 2011 to 31 December 2011, 82% of active clients who used Forex online transaction platforms incurred a loss, while 18% of active clients who used Forex online platforms obtained a profit (see http://www.knf.gov.pl/Images/KNF_forex_18_04_2012_tcm75-30319.pdf). The trend persisted in 2012 above-mentioned indicators remaining at similar levels.

In the opinion of the KNF Office, several factors are causing this. One of the basic circumstances is the fact that the target group of the services on the Forex market are investors categorised as retail clients. Those, in most cases, have significantly limited practical and theoretical knowledge of investing on the capital market, compared to professional clients or eligible counterparties. Thus, this category of investors is characterised by low awareness of the risk related to investing in derivatives.

An additional determinant in this respect is the fact that clients who have decided to use the services rendered by investment firms are often people with none or limited experience as Forex investors.

It should be kept in mind that regulations of the capital market ensure an increased level of protection of a retail client, with a special consideration of cases when their investment decisions relate to complex financial instruments. The scope of the protection is comprehensive and covers the appropriate way of conduct of the investment firms with respect to advertising and promotion of financial services and instruments, the scope and standard of information to be conveyed when signing an agreement with a client, conditions for conducting of appropriateness tests of a service or an instrument, as well as implementation activities related to concluded.

It should be taken into account that the issue of concluding transactions on the market of financial derivatives which are not subject to trading on the organised market (Forex) is vital and constantly monitored, both by the Polish Financial Supervision Authority (the KNF) as well as by European authorities.

Apart from the aforementioned communication of the KNF, the following communications shall be noted:

- communication of the KNF of 22 June 2011 on CFDs (http://www.knf.gov.pl/Images/KNF_CFDs_tem75-28696.pdf),
- communication of the KNF of 6 March 2012 on CFDs ( ),
- communication of the ESMA of 5 December 2011 on investing on the Forex market (http://www.esma.europa.eu/system/files/2011-412_pl.pdf) and
- joint communication of the ESMA and the EBA of 28 March 2013 on contracts for difference (CFD) (http://esma.europa.eu/system/files/investor_warning_-_cfds_-_esma_2013_00070000_pl_cor.pdf)

Although the communications listed above are addressed directly to investors and not investment firms, their elaboration and frequency of placing them clearly reflects the current scale of investment in this segment and significance of issues resulting from transactions concluded on the Forex market. The communications are at the same time a reflection of the approach of supervisory authorities to ensuring a proper level of protection of retail clients' interests – who, due to their theoretical and practical experience or the value of the capital owned, in a majority of cases invest in derivatives available on the Forex market in the increased risk environment, taking into account their individual situation. In the opinion of the KNF Office, the fact that the supervisors dedicate special attention to the protection of the inherently weaker category of investors should in a natural way be taken into account also by the entities authorised to perform services in this segment of the capital market.

In the first place, the KNF Office points out at the overarching rule, imposing an obligation to act in the best interest of a client, expressed in Article 83a(3) of the Act of 29 July 2005 on trading in financial instruments[1], which shall be the fundamental principle of functioning of investment firms in relations with their clients. It is noteworthy that application of that rule of conduct has in practice two different dimensions.

The first dimension consists in the way of interpreting the regulations contained in implementing provisions to the Act. It needs to be indicated that the provisions concerning the way of shaping the relationship between an investment firm and a (existing or prospective) client contain a series of precise requirements that are aimed at protection of their interests, in particular interests of an investor classified as a retail client. The requirement to act in the best interest of the client at the statutory level has implications for any specific norms that result from the lower order (secondary) acts. The way of interpretation of the regulations and creating relevant norms of conduct for investment firms should be determined by the fundamental requirement to act in the best interest of the client. The circumstances which should be considered when interpreting the regulations concerning the conduct of investment firms include, in particular: the category to which a given client belongs and establishing whether actions undertaken by the investment firm take duly into account the optimum protection of the client's interest.

The other dimension of application of the overarching rule refers to the statutory principle of acting in the best interest of the client with respect to any other area of activity of the investment firm, where the scope of the activity in question is not covered by detailed regulations.

In this context, it should be noted that, with respect to the conduct of investment firms, there are several regulations which determine it in detail. However, a broad area of activity has not been subject to such a meticulous regulation. Therefore the rule of acting in the best interest of the client binds investment firms also in all those areas which have not been subject to detailed regulation.

1 Journal of Laws of 2010, no. 211, item 1384, as amended, hereinafter the Act

1. **Standard and conditions of conveying information to existing or prospective clients**

As mentioned in the introduction, in the course of ongoing supervision, a phenomenon of intensified actions of advertising and promotional nature by investment firms has been observed. Actions which, while broadly promoting investment on the Forex market, are aimed at inducing investors to carry out investment activities in that area.

Without negating the increased intensity of those activities by investment firms, adopted within business strategies, the KNF Office wishes, to point to basic legal circumstances which should determine carrying out marketing actions in a proper manner.

What merits particular attention is the fact that the legislator particularly emphasises the significance of correct conduct of investment firms when advertising or promoting the brokerage services. Regulator does that at the level of the Act, in Article 83a(2), stating the overarching requirement that information disseminated by any firm to advertise or promote the said services should be fair and understandable.

Just like in the case of the rule concerning acting in the best interest of the client, also with respect to the statutory requirement concerning features which should characterise information aimed at inducing investor to accept an offer of an investment firm, it is possible to formulate two rules of establishing proper conduct of the company, that is:

- taking into account the principle of investment firm acting in the client's best interest when interpreting secondary (implementing) regulations which determine the detailed aspects of promotion and advertising,
- adopting the rule identified in Article 83a(2) of the Act as the overarching guideline for the conduct expected from an investment firm in the sphere not regulated in detail by the secondary legislation to the Act.

In the scope of the secondary regulations, the KNF Office wishes to point out, in the first place, to the provision of § 9 of the Regulation of the Minister of Finance of 24 December 2012 *on the mode and conditions of conduct of investment firms, banks, which are referred to in Article 70(2) of the Act on trading in financial instruments, and custodian banks*[2], which formulates the basic parameters of information to be disseminated by an investment firm.

In particular, the rule provided for in § 9(1) of the Regulation needs to be pointed out, according to which information addressed by an investment firm to existing or prospective clients should be fair and should not give rise to doubt or mislead.

In the first place, the KNF Office states that the practice of an investment firm evoking false impressions concerning the nature or way of provision of a given service on the Forex market is in conflict, among others, with the legal norm concerning provision of fair information to the client, which is referred to in § 9(1) of the Regulation. According to observations made hitherto, it applies in particular to cases where an investment firm presents to the public the service offered as if it was organisation of a venue of systematic trading in financial instruments, analogous in terms of functionality to types of organised trading. In the message, this offering is usually defined as organisation of a “Forex platform” - expressions with a similar meaning can also be used. Such a presentation of a business model does not lead to reservations in principle only in case, when the investment firm, using its own IT and organisational resources and with involvement of its own capital, develops a system that enables clients to conclude transactions within the system in a

2 Journal of Laws of 2012, no. 1078 – hereinafter: the Regulation

manner that is organised, frequent and systematic. However, some business models of investment firms on the Forex market do not consist *de facto* in organisation of an own "Forex platform", but in provision of a brokerage service through intermediation of other entities. which execute orders submitted by clients in diverse ways, which is in contradiction to the message which suggests that the investment firm independently organises trading.

In addition, the KNF Office wishes to draw attention to the terminological correctness in describing services provided to the client. The above is underlined due to the fact that many promotional materials analysed by the KNF Office have used expressions which do not correlate with the catalogue of brokerage services, as defined in Article 69(2) and (4) of the Act used to define the services. As an example of such incorrect terminology one can quote a statement that an investment firm provides the client with the service of "intermediation on the Forex market" or "enabling investment activity on the Forex market". The regulations for brokerage services provision do not identify such types of services offered by investment firms. Moreover, such phrases often make it impossible to properly identify the nature of the business of the investment firm, e.g. whether the service of *execution of orders* or rather of *reception and transmission of orders* is performed within the scope of "intermediation". Such a practice is in contradiction with § 9(1) of the Regulation, as it does not convey fair and not misleading information on the nature of the performed activity (the service offered) by the investment firm for its client.

Another practice noted in the activities of many investment firms, which shall be mentioned in context of incorrect implementation of the principle referred to in § 9(1) of the Regulation, is excessive emphasis placed on the function of demonstration-type ("demo") accounts.. The KNF Office does not deny benefits stemming from the possibility to use that type of application in order to learn the basic principles of Forex investing, as well as to become familiar with technological infrastructure connected to that market (the functionalities of software made available to an investor for investing activities). Nevertheless, the KNF Office believes that in the light of § 9(1) of the Regulation the correct conduct is to indicate all aspects and conditions, which are related to possible investments. For it is beyond doubt that investment decisions taken without real involvement of own assets, with the use of a demo account, are connected with a lower emotional involvement of the investor, and thus differ from investments with the use of real money. Therefore the degree of rationality of undertaken actions in the environment of the demonstrative account and real investments may likely differ. In the KNF Office's opinion, an investment firm should place information the essence of which will be to signal that investing in the demo environment and in reality are not similar in terms of conditions for making decisions. This remark is in particular justified as clients encouraged by positive results on Forex with the use of demo accounts will likely assume that they will obtain similar results in real life.

Notwithstanding the remarks presented above, based on the past supervisory experience, it becomes important in the opinion of the KNF Office to present also a set of detailed remarks concerning in particular the way of presenting information on investing in derivatives.

According to the KNF Office, the practice of sending to clients, especially retail ones, any messages in the framework of advertising and promotional campaigns, which contain information on benefits to be obtained from investments on the Forex market, omitting any information on the possibility of incurring a loss, shall be considered as conflicting with the principle expressed in § 9(1) of the Regulation.

Another practice which must be considered incorrect is bias (lack of balance) in the message concerning, on the one hand, the possible profits which are related to investing in specific Forex instruments, and on the other hand, the risks of incurring a loss in such transactions. The KNF Office notes not only the lack of balance in the contents of the message as such, but also lack of

proportion in other areas e.g. graphic presentation of potential benefits and losses or differences in placement of one of the two elements in advertising and promotional messages, shall be considered as asymmetry of information (bias)

Based on supervisory observations, the KNF Office found that what specifically violates the principle of reliability of information, as well as not misleading to clients, is the practice of information messages which focus in promotional and advertising materials only on possibilities and opportunities, which are offered by investing on the Forex market. This remark in particular is applicable in the case of insistent underlining in promotional and advertising materials of the supervised entities of benefits stemming from the so-called financial leverage effect, which is well known for being an extremely risky mechanism when investing in derivatives, and of which a retail client may not be aware, or their knowledge will not allow the correct perception of the essence and scale of risk related to leverage.

Such kinds of practices are not only conflicting with § 9(1) of the Regulation, but also are contradictory to § 9(2)(3) thereof.

As a result of the ongoing supervision activities, another practice was noted, i.e. of including contents which use advanced concepts of economics and finance, as well as excessively sophisticated financial vocabulary in informational material. This practice in shaping contents of the message must generally seem incorrect in the light of § 9(2)(2) of the Regulation in the case of addressing the informational message to investors who are or could well be retail clients. According to the said provision, information should be presented in the way understandable to an average representative of the group to which it is targeted or which it may reach. It would be hard to believe that the recipients of that type of information, that is prospective or existing retail clients, manifest extensive specialist knowledge in the field of economics and finance.

The negative assessment of informational material using sophisticated economic and financial terminology is enhanced by a closer look at the contents of provision § 9(2)(2) of the Regulation. As a reference for the requirement of comprehensibility of disseminated material, the Regulation assumes an average group representative. It does not refer, however, to an average representative of a given client category. Various groups may be included in the category of retail client. It means in practice that if information is addressed to a broad range of recipients, it shall be formulated in such a way that makes it understandable for an average representative of any group which might potentially be reached with that informational material. Frequently, in the case of wide dissemination of material in a public manner, it will logically require such a drafting of the contents that it will make the message understandable to a typical representative of the group with the lowest awareness of the principles of functioning of derivatives.

KNF Office points out that the standard of information, which is transmitted to an existing or prospective retail client, is covered also by the provision § 9(4) of the Regulation. Pursuant to which, investment firms are allowed to provide to existing or prospective retail clients a marketing message indicating past results obtained in investments on a given financial instrument or in relation to a specific financial index or provision of a brokerage service, which is identified in Article 69(2) of the Act. The provision, at the same time, establishes conditions of presenting past results, stipulating that such messages shall:

- not be presented as the most important element of the message;
- be reliable and cover data for the period of last 5 years or the whole period in which the financial instrument is offered, a given financial index was established or a given brokerage service has been provided, when the period is shorter than 5 years or a longer period, selected at the discretion of the investment firm. In any case, the data must be based on full 12-month periods;

- clearly identify the period for which data is presented, and the source of data;
- contain a clear warning that the presented data concerns the past and that results obtained in the past do not guarantee similar outcome in the future;
- if they are based on amounts expressed in foreign currency – identify the currency with warning that possible profits may be increased or decreased as a result of exchange rate changes ;
- if presented as gross results– describe the impact on result of any margins, fees and other burdens related to a given financial instrument or brokerage service.

The validity of the above requirements in juxtaposition with the observed practice of investment firms results in a negative assessment of the advertising and promotional materials disseminated by investment firms, which contain brief data on a specific rate of return from investment, with reference to investments of a personalised investor, made in an unidentified reference period.

In the context of proper performance by an investment firm of the duties resulting from the provisions of the Act or the Regulation, including also in the scope of the above-mentioned provisions of § 9(1) of the Regulation, KNF Office recognizes the special role of the unit for supervision of compliance with law which, pursuant to § 14(5) of the Regulation *of the Minister of Finance of 24 December 2012 on determination of the detailed technical and organisational conditions for investment firms, banks, which are referred to in Article 70(2) of the Act, and custodian banks and the conditions of assessing by brokerage houses of internal capital*[3], performs within legally defined obligations advisory and ongoing assistance to related persons who perform actions within of brokerage activity carried out by an investment firm. The assistance helps them fulfil their duties in compliance with the legal acts that regulate the performance of brokerage activity. Bringing this concept into life in the field of information policy means that all kinds of materials submitted to clients, including of promotional and advertising nature, should, before dissemination, undergo thorough analysis and verification by compliance unit for formal and material correctness.

2. **Assessment of appropriateness (further referred to also as: adequacy) of financial service and instrument for the client**

What is another key issue related to investing on the Forex market is investment firm and the client awareness of adequacy of the planned investment to the client's knowledge and experience resulting from his/her past investments on the capital market.

The regulations of the Polish capital market law provide for a series of conditions, directly or indirectly tackling that issue.

However, it should be pointed out that the basic tool for implementation of the above goal is properly performed appropriateness test of brokerage service and offered financial instrument which is to be the subject of the service provided under the concluded agreement. The KNF Office wishes to draw attention to the fact that, in case of derivatives, investment firm is obliged to request the existing or prospective retail clients to present information on their knowledge and experience in order to make the assessment (§ 15 in conjunction with § 20(2) of the Regulation, the latter read *a contrario*). These actions (collecting an appropriate amount of data) undertaken by the investment firm shall lead to assessment whether a financial instrument or brokerage service provided under the agreement are appropriate for the given client, taking into account his/her knowledge and experience. Put differently, it means that the investment firm is obliged to obtain legally required information to establish, whether the client is aware the risks related to investment in derivatives on

3 Journal of Laws of 2012, item 1072, hereinafter referred to as “Regulation on technical conditions”

the Forex market.

When analysing the conduct of investment firms in the framework of appropriateness tests, the KNF Office identified a group of issues which lead to objections of the supervisor as to their correctness.

In the first place, the KNF Office underlines the fact that, pursuant to § 21(1) of the Regulation, an investment firm shall not undertake directly or indirectly any actions which could foster existing or prospective client's failure to present information necessary for the test.

In the light of the above condition, the KNF Office believes that an excessive emphasis in the appropriateness test form being put on a statement that a lack of client's response to the questions posed would not preclude conclusion of the agreement (transaction), shall be considered improper conduct. In this case it needs to be concluded that the investment firm diminishes the importance of appropriateness test and evokes an impression that carrying out that assessment is an unnecessary obstacle to the opportunity to undertake investment. Similarly, this applies to the activities of employees prompting an investor to resign from filling in the test or picturing the test as a mere formality or a burden, which brings no real benefits.

Performing the appropriateness test, as indicated above, is one of the key tools of protecting the investor interests. What needs to be considered important is obtaining by the existing or prospective client, as a result of the appropriateness test performed by the investment firm, information that a financial service or instrument is not adequate for them, as they do not realise the risk related to investment. Awareness that the intended investment activity covers financial instruments whose structure and principles of functioning are not properly understood by the investor will enable him/her to rethink the rationale and purpose of planned transactions. Thus, it is likely that the client abandons the idea of investing on the Forex market and benefits from other – better known to the investor – investment opportunities offered by the capital market. The investment firm conduct of undertaking active action to collect the information necessary for making the test, explain to the existing and prospective client the role of the performed test or make him/her aware of possible adverse consequences of investment in instruments unknown shall build a mutual relationship based on trust in the investment firm and create the ground for permanent presence of the investor on the capital market.

The KNF Office assumes that the range of factual situations which lead to the effect in the form of discouraging existing or prospective clients from presenting information required for carrying out the assessment may be difficult to identify and the investment firm itself could have doubts whether the actions undertaken by it may cause the said effect.

Having regard to the importance of the issue of appropriateness test, the KNF Office thinks that an investment firm should specifically and regularly analyse whether its actions or activities of its employees are in conflict with the requirement resulting from § 21(1) of the Regulation. The tools which can be used to carry out such a study may vary and can be picked at different stages of rendering the investment service. For instance, the KNF Office indicates, that, for the purposes of assessment of regularity of informational materials, the structure of the test used in the assessment or regularity of the conduct of employees of the investment firm, it may be important for the investment firm to find out what is the share of investors who refused to provide information legally required in relation to all investors covered by the obligation to undergo assessment.

The procedure to be followed when performing the appropriateness test is regulated in detail in § 15 of the Regulation.

Typically, investment firms implement the obligation resulting from the aforementioned legal regulation, by developing and using an appropriateness test (written or in electronic format) – a form that contains a set of questions posed to the investor, concerning his/her knowledge and experience.

The solution undoubtedly systematises and facilitates the process of performing the appropriateness test by an investment firm.

However, when evaluating the appropriateness tests used, the KNF Office identified a catalogue of practices, which seem to be conflicting with the requirements of § 15 of the Regulation.

In the first place, appropriateness tests used by some investment firms did not contain questions that would determine obtaining all of information required under § 15(2) of the Regulation. Such conduct is in obvious contradiction to the legal provisions.

Moreover, in the light of § 15(1) of the Regulation, obligation to perform the appropriateness test lies with the investment firm rather than with the existing or prospective client. In this context, it shall be noted that the questions formulated within the evaluation of the client's investment profile should enable obtaining detailed, objective information with respect to facts and numbers, which does not leave room for self-evaluation made by the client, in order to properly meet the legal requirement resulting from the Regulation by the investment firm. In view of the above, the observed practice consisting in asking questions formulated in a way which forces investor to perform subjective assessment of his/her own knowledge and experience is incorrect.

As stated above, obtaining a set of information by the investment firm is to enable it to assess whether the brokerage service or a given financial instrument which is to be the object of investment are appropriate for a client. In view of the sense and purpose of the performed activities, the investment firm should obtain clear, precise and adequate information, falling within the scope outlined in § 15(2) of the Regulation with respect to those financial instruments (in the case of the Forex market: derivatives), which are to be the object of planned investment.

As a consequence, the practice where an investment firm fails to request provision of information in the scope of the instruments which are to be the object of the planned brokerage activity, and where it obtains data only concerning other types of financial instruments, needs to be regarded as failing to fulfil the purposes of appropriateness test. For this type of conduct does not bring any useful information on the real, hands-on investment experience of the existing or prospective client in the scope of the investments which are the object of the planned investment. Thus, the investment firm does not have a full basis for establishing the existence of appropriateness of a financial instrument – whether the investor, granted his/her possessed practical and theoretical knowledge, is familiar with the mechanism of functioning of the instrument and with the investment risk.

What also needs to be considered as conflicting with the purpose of performing the appropriateness test is the practice, as identified within the supervisory activities, where an investment firm requests to provide information on the knowledge and experience, referring the question, however, to financial instruments in general, or, although diversifying questions based on classes of financial instruments, combining types of financial instruments substantially different in nature in one class. Such conduct of investment firms, in the opinion of KNF Office, should also be deemed as conflicting with the purposes of the test, as the investment firm fails to obtain information of the actual level of knowledge and experience in the scope of derivatives, necessary to perform the test.

KNF Office, reconsidering the opinions and positions presented above, wishes to point out to the fact that what becomes methodologically correct for the purposes of carrying out the

appropriateness assessment is obtaining information on the nature, volume and frequency of transactions with reference to specific types of financial instruments, in particular those covered by the service, rather than information referring mainly to broadly understood class of financial instruments of various structure and different investment-risk level.

The appropriateness tests (forms) used by investment firms in practical application of the provision of § 15 of the Regulation, besides obtaining information in an orderly and uniform way, contain also a mechanism that enables obtaining information whether a given person or instrument is appropriate for the existing or prospective client. In order to facilitate the verification process, the tests assign scores to specific responses to questions, establishing at the same time score thresholds, the reaching or exceeding of which results in considering the brokerage service or financial instrument to be appropriate. Without questioning the use of that sort of solution, the KNF Office wishes, nevertheless, to stress that both determining the scores for specific responses and establishing the minimum threshold should be preceded with a detailed analysis whether the values have been set at the appropriate level. In other words, whether the score determining appropriateness of the service or instruments has been defined properly, in particular if the threshold has not been set too low. Improper establishment of the score limit may lead to deciding that a service or financial instrument, as a result of application of the test, is appropriate for the investor, while the result of the actions of the company would have been completely different with the application of individual solutions.

An investment firm may, at its discretion, apply various solutions to obtain the information on correctness of establishment of the threshold and the scores awarded for specific questions. As an example, the KNF Office indicates that it might be useful to carry out a simulation of responding by clients with different profiles, analysis of the obtained results and appropriate modification of the score thresholds in order to calibrate them at the right levels.

Another solution that would serve to optimise the appropriateness assessment would be introduction of solutions with a dynamic, advanced nature, i.e. consisting in asking subsequent questions or awarding scores for specific responses depending on the way of answering the prior questions.

With respect to scoring system, a practice was also observed of obtaining data exceeding the area required by § 15(2) of the Regulation and awarding scores for answers given. Thus, the information obtained beyond the scope of § 15(2) of the Regulation influence the total score awarded to a client and determine the final assessment of the client. Such a method may lead to a situation where number of points awarded for additional information will be the main factor determining positive assessment of appropriateness of a brokerage service or financial instrument. The KNF Office wishes to explain that it is not questioning the method in which investment firm collects additional information concerning a client since this deserves approval, as it might enable more comprehensive examination of the client in certain cases. The data may, however, serve only to perform additional analysis concerning the client. The information shall though not be a component of the score equal to questions resulting strictly from the criteria laid down in § 15(2) of the Regulation, as the actual picture of the knowledge and experience becomes distorted this way. This distortion will take place in particular when the client has obtained a relatively low score for questions concerning the essential criteria, the elements listed in § 15(1) of the Regulation, while obtaining a high score for information not closely related to the aim of the performed test.

3. **Classification of actions performed for the client in light of the list of brokerage activities referred to in Article 69(2) and (4) of the Act**

Having regard to the analysis of activities of investment firms on the Forex market, it is also justified to pay attention to the issue of proper classification of brokerage activity. An investment

firm, when considering the standard of information forwarded to existing and prospective clients that result from Article 83a(2) of the Act, made more specific in § 9(1) of the Regulation, shall identify in a clear and not misleading manner, exactly what type of brokerage activity will be delivered to the existing or prospective client. It should also be signalled that the information regime regarding informing the prospective client about the nature of the brokerage service provided for the client has been additionally strengthened by the provision of § 10(1) of the Regulation, which *expressis verbis* imposes on the investment firm the obligation to provide the prospective client, before conclusion of the agreement for the provision of brokerage services, detailed information about the service to be rendered under the agreement.

Implementation of the above-mentioned requirements does not only guarantee transparency of the conduct of the investment firm with respect to the binding regulations, but also enables investors to precisely determine on their own the effects of brokerage services provided, as well as precisely determine the rights and obligations that result from the contractual relation that will bind them to the investment company.

The practice of functioning of investment firms shows that in relations with clients, firms use terminology concerning their activity which might lead to doubts as to the actual, true type of rendered brokerage services.

This kind of practice can be traced down in informational materials targeted to investors. Furthermore, terminology which does not conform with legally defined types of brokerage services, is also used in rules and agreements binding in contractual relations with the client. For instance, cases have been recorded where an investment firm described the nature of its activities as "*service of intermediation on the Forex market*" not explaining to which of categories under Article 69(2) and (4) of the Act the service belongs. In light of § 24(1) and (13) of the Regulation, it should be clearly and unambiguously identified, exactly what kind of brokerage service shall be rendered on those grounds.

In addition, within the performed ongoing supervision, the KNF Office noted the practice of tagging a brokerage service as *reception and transmission of orders*.

In the first place, the KNF Office indicates that in some of the analysed cases the service of executing orders of purchase and sale of financial assets for the account of the client placing an order, which is referred to in Article 69(2)(2) of the Act, was actually rendered. This statement results from the fact that the investment firm, based on an order from a client or clients, placed, in accordance with rules it had adopted, the order for them with a different entity, which executed the received order. As a matter of fact, therefore, the investment firm independently used a different entity for executing received orders.

As regards the problems of performing the activities of reception and transmission of orders of purchase or sale of financial instruments, i.e. the activity referred to in Article 69(2)(1) of the Act, the KNF Office explains that the essence of the service (in the form referred to in Article 74b(1)(1) of the Act) amounts to transmitting a client's order to a different entity for execution. The role of the investment firm amounts to fulfilling the role of "transmitter, messenger" – entity that conveys the declaration of will, without modifying it. In the case analysed, the result of that action – transmission of a client's order, is obtaining such a declaration of will of the client concerning the purchase or sale of a financial instrument by an entity authorised to execute that order. In this case, it is the entity executing the order which provides service to the client.

It should be stressed that the process of executing an order in the above scheme requires the existence of two contractual relations, i.e.:

- the relation client –investment firm which receives and transmits the order (as the basis for transmitting the order to the entity which executes the order) and
- the relation client –investment firm which executes the order (as the basis for executing the order for the client by an authorised entity).

It is permissible to conclude an agreement between the client and the investment firm that executes the order through intermediation of the investment firm which receives and transmits the order. Nevertheless, existence of two contractual relations is a condition *sine qua non* for correct execution of the transaction. Conclusion of the transaction only with the investment firm which collects and transmits the order for the purpose of execution elsewhere, without setting up a legal relation client – the investment firm executing order, results in a situation where the executing entity has no legal basis for effective execution of the order.

4. **Content of the contractual relation with the client**

According to observations of the Polish capital market as regards investments on the Forex market, the current offer of investment firms is addressed mainly to retail clients, which results in certain regulatory consequences as to the way of shaping and the scope of contractual relations. In light of § 24(1) and (2) of the Regulation, an investment firm which renders a brokerage service to a retail client (with the exclusion of the situation when the agreement is concluded in relation to the business activity conducted by the client), will be obliged to provide the service on the basis of appropriate internal rules and contract. It needs to be indicated that, due to the standardisation of the principles of concluding transactions on the Forex market, and the parametrisation of the object of transaction, the exception referred to in § 24(3) of the Regulation will generally not apply.

The provisions of the Regulation stipulate in detail that the internal rules of rendering a brokerage service shall define the method of rendering the service to a client, including the rights and obligations of an investment firm and a client thereunder, as well as the conditions for concluding and terminating the contract.

Based on foregoing analyses of the provision of brokerage services on the Forex market, the KNF Office states that, as regards the content of contractual relation client –investment firm (defined both by the provisions of the above mentioned internal rules and the contract), broadly understood principles of execution of the clients' orders are the key issue. It pertains in particular to proper conditions and standards of quoting the prices of derivatives, i.e. provision, on an ongoing basis, of correct purchase and sale prices (commonly tagged as *bid* and *ask*) together with the *spread* – difference between bid and ask prices (the *two-way price quotation* principle). Correct and continuous quoting is fundamental from the point of view of investors' interests. This is because a defined quoting procedure means that the risk for the client of a loss resulting from erroneous or late dissemination of prices of financial instruments or underlying significantly drops.

Correct and continuous quoting attests the level and quality of the service rendered by an investment firm. In the current market practice, two models can be distinguished. The more widespread model is one in which the investment firm informs its client that quoting is based on data from external sources. The other model is the investment firm indicating to the client that it makes the quotation of prices of financial instruments on its own. With respect to those two models, one should note the objective fact that prices are basically never quoted by an investment firm in complete detachment from external sources. Even when an order is executed through a transaction concluded with an investment firm, the price offering remains based on real market conditions. Those in turn are established on the basis of data obtained from specified sources. Client's knowledge about these sources may not be important, when the investment firm is liable to the client for improper execution of an order due to erroneous quotation, without differentiating

between (i) causes of occurrence of the error attributable to the investment firm and (ii) causes attributable to the entities which are sources of quotation data. However, reference to external sources becomes significant when contractual relations between the investment firm and the client are shaped in such a way that the investment firm bears limited liability for damages or does not bear liability for damages in the case when the transaction was concluded on the basis of erroneous quotation[4] received from an external source (and thus there is a modification of liability compared to situation where error in quotation was caused by a circumstance attributable to the investment firm). It needs to be noted that in the latter case the client should have a real opportunity to verify the exact moment of generation of an error, and thus the scope of liability to be claimed.

In view of the above, the investment firm should clearly identify the source of price quotations. If there are several sources, and the use of a specific source dynamically changes, this circumstance should be clearly identified in the internal rules, and the possibility of establishing *post factum* the source of data for quotations for a specific transaction should be appropriately secured. What is of great importance is provision of § 9(2)(4) of the *Regulation on technical conditions*, pursuant to which the investment firm should record data related to performed brokerage activity and activities performed by each particular internal unit.

In the context of the provision of § 9(2)(4) of the *Regulation on technical conditions*, one should pay adequate attention to the necessity of record-keeping, and to registration of any changes introduced manually to automatic transaction systems employed in the investment firm.

Summing up the above, it needs to be stressed that in the opinion of the KNF Office, it is not permissible to limit the liability of an investment firm for improper execution of an order by referring to errors of external entities, in situation where the investment firm does not provide its client with an opportunity to verify fully the circumstances of the occurrence of the errors.

Undoubtedly the process of price quotation of financial instruments may be encumbered with errors consisting in deviation of the price of a financial instrument from the price of the underlying, or shaping of the price of a derivative as a result of occurrence of abnormal market phenomena, thus creating an extraordinary situation. The practice identified by the KNF Office consists in including in the internal rules of rendering a brokerage service an exclusive right of the investment firm to withdraw from a transaction in case of occurrence of such extraordinary circumstances, which caused the anomaly in quotations. This case should be assessed as creating provisions limiting rights of the client without maintaining symmetry with respect to the rights of the investment firm. Disregarding the fact that such proceeding can qualify as a prohibited contractual provision in light of Article 385^3 of the Act of 23 April 1964 the Civil Code[5], such a conduct infringes the principle of acting in the best interest of the client, which is referred to in Article 83a(3) of the Act.

In view of the need to ensure symmetry of rights for each party to a transaction, each of them (both the investment firm, and the client) should have the right to withdraw from concluded transactions in the same circumstances and on the same terms and conditions.

Notwithstanding the foregoing, also another practice observed by the KNF Office is related to the analysed issue, which is investment firms using too general and imprecise clauses describing circumstances which constitute the "*erroneous quotation*" and their consequences for concluded transactions., In the case of proper identification of sources of quotations, there should be no difficulty with identification of the difference between the price at which the transaction was

4 Understood as establishment of a price diverging from the market price to a degree indicating that if the parties at the time of concluding a transaction had known that the price did not correspond to the market price, at least one of them would not have concluded the transaction;

5 Journal of Laws, no. 16, item 93, as amended.

concluded and the price provided by the relevant source (taking into account permanent/justified modifications made by the investment firm – extending the *spread*), constituting an error. However, at this point it should be stressed that identification of such a difference is much more difficult when error was generated by the source of quotations. In the latter case, it becomes necessary to set right parameters to the values which will determine deeming any transaction to be erroneous. It should be indicated at this point that occurrence of "erroneous quotations" often constitutes the basis for withdrawal from a concluded transaction or correction of its terms and conditions. Therefore, in the opinion of KNF Office, the investment firm, in order to guarantee transparency of proceeding when rendering a brokerage service, and for equality of rights of both parties, when defining "erroneous quotations", should precisely indicate the value or methods, which will determine considering quotations as erroneous.

Yet another aspect which might affect execution of client orders on Forex market in the context of extraordinary situations is suspension of trade in an underlying and effects of such a suspension. The KNF Office states that it is a common practice for the investment firm, when obtaining information on suspension of trade in a given underlying on a given market, to immediately suspend reception of orders for financial instruments with simultaneous provision of that information to the client, e.g. by means of the transaction system or by phone.

It should be remembered that, although suspension of the underlying is a circumstance independent of the investment firm, conclusion of a transaction by the client on the basis of a quotation provided by the investment firm, after suspension of the underlying, may not be considered a circumstance independent of the investment firm. The KNF Office assumes that possible consideration of conclusion of transaction in the above situation as a circumstance which 'was beyond the control' of the investment firm shall depend on the time of concluding the transaction in relation to the suspension of the underlying. Such a consideration shall not be justified by concluding a transaction after time which made it possible for the investment firm to react to the suspension of underlying.

Thereby, the KNF Office states that the following situation is a practice that violates the principle to act in the best interest of a client: when an investment firm does not deem a quotation as self-inflicted erroneous when a client concluded a transaction due to refraining by the investment firm from blocking the reception of orders for derivatives in a course of time that cannot be regarded as immediate in relation to the moment of suspension of quotation of the underlying.
What is another practice in the area of extraordinary situations (making execution of a transaction of a client on the Forex market impossible), which in the opinion of the KNF Office cannot be considered correct, is the practice of general identification in the internal rules of the "inoperability of the transaction system", as a circumstance excluding any liability of an investment firm– without providing any detailed causes for such a circumstance. Objectively speaking, the above circumstance is an event which may have various causes, including some attributable to the investment firm. It must be indicated that a list of extraordinary events included in the internal rules can't be the basis for unjustified limitation of contractual liability of an investment firm. Such a list is to serve as general identification of circumstances which could objectively be beyond control of an investment firm, which would rightly lift the firm's liability for the consequences of such circumstances.

5. Issues connected with outsourcing of IT systems used on the Forex market

The institution of outsourcing gets particularly important as far as the Forex market is concerned. The essence thereof consists in entrusting performance of a given action or a series of actions (e.g. making up a process, service) upon another entity, based on an agreement concluded between the investment firm and the entity, which in a different case would be performed by the investment firm itself. In relation to the last of the above elements, the essence of outsourcing refers to obligations

of an investment firm resulting from the legal regulation. The presented view concerning the nature of outsourcing corresponds to the understanding adopted by the EU legislator.[6]

The institution of outsourcing, introduced under Article 81a of the Act - consisting in entrusting by the investment firm to a domestic or foreign entrepreneur by way of an agreement made in writing, performance of certain actions related to activity of the investment firm, including the brokerage activity conducted - creates great room for various business models to be adopted by investment firms.

Having regard to the necessity to ensure conducting activity in a way that does not threaten the security of trade in financial instruments and to ensure protection of the investor, the EU legislator (within the MIFID system[7]) followed by the Polish legislator (within, among others, the provisions of the Act) have introduced a list of conditions which determine the legality of the outsourcing institution. The above-mentioned requirements refer symmetrically to both domestic and foreign entrepreneur that perform actions referred to in Article 81a of the Act, as well as the investment firm. A detailed list of requirements that ensure compliant performance of outsourcing function is contained in particular in Article 81b of the Act. The list concerns both the requirements to possess specific entitlements to perform actions within the scope of the subject-matter of the agreement, as well as the need to have knowledge and experience necessary for performance of the provisions of the outsourcing agreement. The requirements concern also the financial situation of the entrepreneur that performs the actions defined in the agreement under Article 81a of the Act that ensures proper performance of the agreement.

As mentioned above, the requirements concerning outsourcing concern also the investment firm, which shall be obliged, among other things, to ensure ongoing supervision and perform current assessment of the quality of the performed actions, entrusted under the agreement referred to in Article 81a of the Act. Notwithstanding the foregoing, the requirement to have appropriate protection plans providing for ways of recovering data protected against their loss caused by a power cut, other failures or fortuitous events, and periodical performance of tests in the scope of regularity of the functioning of the devices and systems used to recover data has been placed on both the investment firm, and the entrepreneur. At the same time, one of the requirements for outsourcing is to ensure that the entrusted actions will not affect adversely investment firm's compliance with legal regulations, prudent and stable management of an investment firm, efficiency of internal control system and protection of professional secrecy or legally protected or confidential information..

It needs to be underlined that the legal scope of entrusting of activities to another entity is not unlimited. What is important in this respect is the provision of Article 81a(2) of the Act which contains a catalogue of situations and groups of activities with respect to which outsourcing is prohibited. For instance, prohibited in the light of the Act (Article 81a(2)(1)) is a situation where an investment firm outsources its brokerage activity to a different entity – to such an extent that the service is in fact provided exclusively by another entity (insourcer), not the outsourcing firm (which

6 See Article 2(6) of Commission Directive 2006/73/EC of 20 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (the so-called implementing directive, OJ L 06.241.26).

7 The MIFID system covers Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 200012EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC), the implementing directive and Commission Regulation (EC) no. 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive.

would become a "*letter box*" entity). In the practice of operations of investment firms, the above scheme can be observed *inter alia* in the following real situations:

- clients submit orders directly to transaction platforms run by foreign partners of investment firms,
- orders are verified in terms of coverage, and then executed and cleared, with no involvement of IT systems of the investment firm with which the client has signed an agreement for provision of brokerage services (including execution of orders),
- the outsourcing investment firm has no administrator authorisation with respect to the functionalities of the applications (platforms) of its foreign insourcing partners, thus it only uses the platforms, neither it has any authorisation with respect to the mode of concluding transactions and the way of executing them, correction or cancellation of a client's order executed on transaction platforms of foreign partners,
- purchase and sale of financial instruments on account of the client does not take place as a result of operations of the investment firm and through its IT system, including: i) verification of the value of the margin to cover the order, ii) cancelation or correction of a closed and cleared position, but only as an effect of execution of the client's order by a foreign partner of the investment firm on the foreign partner's transaction platform, from the moment of placing the order to clearing of a closed position.

Carrying out brokerage activities in circumstances presented above constitutes a violation of Article 81a(2)(1) of the Act by entrusting (outsourcing) performance of brokerage activities based on Article 69(2)(2) of the Act (and other articles) to foreign entrepreneurs in a manner leading to lack of real performance by the investment firm of the actions resulting from the above-mentioned brokerage activity.

At the same time, based on the supervisory experiences, the KNF Office indicates that investment firms conclude with third parties agreements referred to as *white label*, which, in the light of current Polish regulations, are not named agreements, legitimacy of which results from general principle of contractual freedom. Important reservation is that the factual and legal effects of such a contract for an investment firm and its clients shall be subject to assessment in light of provisions of the Act and secondary legislation issued on its basis. Agreements of the *white label* type, which are scrutinised by the KNF Office, are characterised among others by the fact that based on a license permitted upon a fee, a foreign partner (third party) commits to enable an investment firm access to a transaction platform/s through a terminal/s labelled with the investment firm's own logo. The investment firm, based on the *white label* agreement, purchases also the rights to use the IT infrastructure (hardware) of the foreign partner.

Having regard to the above contractual clauses, characteristic for the *white label* agreements, KNF Office indicates that their analysis leads to a conclusion that thereupon the investment firm has entrusted performance of the brokerage activity in a way that leads to no real performance of a given action under the brokerage activity by the investment firm, which constitutes a violation of Article 81a(2) of the Act (the *letter box* formula). The KNF Office wishes at the same time to point out to the fact that the investment firm, before conclusion of the *white label* agreement, should thoroughly analyse whether the provisions of the agreement do not infringe the provisions of the Act, including Article 81a(2) of the Act.

Notwithstanding the foregoing, the KNF Office states that the regulatory regime concerning the institution of outsourcing, which includes, among others, the above requirements, meeting which constitutes the *sine qua non* conditions of legality of outsourcing, is not of absolute nature. Regulations concerning outsourcing basically pertain to those agreements concluded by investment firms, the subject-matter of which are actions <u>of major importance</u> for proper performance by the investment firm of the responsibilities defined in regulations. What is essential for the interpretation

of the actions of major importance is Article 81f of the Act, which permits exemption from application of the regulatory regime resulting from Article 81b-81e of the Act. The provision of Article 81f contains, among others, an open list of actions which shall not be subject to the regime of outsourcing due to the fact that they are of no major importance for proper performance by the investment firm of obligations defined in the regulations, financial situation of the company, continuity or stability of performing the brokerage activity by the investment firm.

In the opinion of the KNF Office, that provision of 81f of the Act is key for solving the issue how to classify systems of processing brokerage orders supplied by a third party (a foreign entity), which occurs in practice of investment firms.

The KNF Office assumes that the tool mentioned above, offered by an entrepreneur, is a solution of the IT nature, functionality of which is limited to technical transmission of orders to a foreign investment firm (foreign broker). Client orders are still submitted by means of own investment firm's transaction system. At the same time, the functionality of the system will not enable interference with the content of an order, replacing it, the standard of execution etc. The obligations of an investment firm concerning best execution of orders, which is referred to in § 47 and other of the Regulation, as well as the issue of allocation of orders in the case that clients' orders are executed together with the investment firm's own orders or orders of other clients, i.e. in the mode of § 45 of the Regulation, may not be transferred upon the functionality of the system. The functionality of the IT solution may not enable changing the order parameters: including its price, volume, the financial instrument which was originally selected, amounting to implementation of the best execution policy of the investment firm. An introduced IT system shall be responsible for transmitting, in a strictly technical sense, the investment firm's client's orders to a foreign investment firm (a foreign broker) for the purpose of further execution, and shall have a standardised service nature.

With regard to the above practice, KNF Office indicates that IT devices and systems utilized by an investment firm as the basic method of executing clients' orders constitute a natural, fundamental tool box which determines the potential to perform the brokerage activity in question. The legislator imposed also a series of requirements related to using of IT devices and systems by an investment company in the course of performed activity. An example of those obligations is offered by the provisions of § 11(1)-(3) of the *Regulation on technical conditions*. As a consequence, the IT solution that enables transmitting broker orders of an investment firm's clients to foreign brokers for their execution shall be considered as a solution covered by the regime of Articles 81b-81e of the Act.

At the same time, the KNF Office notes that, in case of a change of functionality in a way permitting a possibility of a change of content of an order by the order-processing system or further interference in broker orders transmitted by means of that system, there will be implied changes connected to outsourcing requirements. For this type of activities should be classified as actions related *sensu stricto* to execution of orders of purchase and sale of financial instruments. As a consequence, pursuant to Article 81b(1)(1) of the Act, the entrepreneur on whom the investment firm entrusted performance of that activity, would have to hold relevant authorisation for performing the activity corresponding to the broker service of the given type.

To conclude analysis of the aspect above, the KNF Office states that the regulations concerning outsourcing in the case of IT systems of a brokerage house shall cover only standard, ongoing activities falling within the scope of maintenance and administration of the system, within the scope corresponding to the obligations imposed on the investment firm by the provisions of the Act, as well as of the Regulation. On the other hand, an agreement with the supplier of IT services, which concerns purchase of specialized software or a license for the use of software and its

implementation, as well as IT assistance meaning supply of updated software for new requirements, technical assistance and maintenance understood as removing critical failures of the system i.e. those that require intervention of the system's owner, shall not be considered to be an agreement referred to in Article 81a of the Act (an outsourcing agreement).

Notwithstanding the foregoing comments, in context of the Forex market, the KNF Office indicates that taking into account the provisions of Article 81f of the Act, quotations of financial instruments collected from third parties, as long as they are standardised, replaceable services, addressed to a broad spectrum of recipients, shall not be covered by the regime of the provisions of the Act concerning outsourcing.

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