

# RISKS IN SECURITIES TRADING

3rd Edition

**Information Brochure  
on Types of Financial Instruments  
and Associated Risks**



LIECHTENSTEIN  
BANKERS ASSOCIATION



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# Introduction

## I. Purpose and content

Trading in financial instruments holds opportunities, but also financial risks. To understand the various financial instruments and to recognise and limit the risks associated with them, knowledge of their essential characteristics and risks is necessary. For this reason, the law of the European Economic Area (EEA) and the Liechtenstein Banking Act and Banking Ordinance demand of the Liechtenstein banks that:

- they conduct themselves in a fair, honest, and professional manner in the best interests of their clients when performing investment services, and
- they provide appropriate information in an understandable form to their existing and potential clients on the financial instruments offered.

Against the background of this legally prescribed information requirement, this brochure aims to provide you with information on the basic terminology, the most important types of financial instruments, and the risks associated with these financial instruments.

**SECTION ONE** briefly describes potential general risks in connection with investments in financial instruments.

**SECTION TWO** discusses the special characteristics and risks of specific groups of financial instruments in more detail. "Risk" in this context means the non-achievement of an expected return on invested capital and / or the loss of up to the total value of the invested capital. Depending on the structure of the product, these risks may be due to several causes – located in the product, the markets, or the issuer. These risks

cannot always be foreseen at the outset, so that the remarks contained in this section should not be considered exhaustive. Due to the dynamic development in the securities trading business, this brochure can likewise not make the claim to comprehensively describe all possible or conceivable financial instruments and product groups. Accordingly, this brochure has deliberately not been designed as a comprehensive reference.

**SECTION THREE** contains special information on investments in emerging markets, guarantees, and securities lending.

Supplementing the information presented in Sections One and Two, **APPENDIX 1** contains a brief tabular overview of selected financial instruments, their special features, and their characteristic risks.

The terminology and technical terms used in this brochure are based on the applicable laws. The term "financial instrument" used in this brochure is an umbrella term for all securities, book-entry securities, and derivatives, including those not standardised or traded on an exchange or regulated market. An exhaustive list of the financial products covered is contained in the Liechtenstein Banking Act and reproduced in **APPENDIX 2**. The term "securities", also used in this brochure, includes all fungible securities that are negotiable on the capital market.

Please read this brochure carefully, and ask your bank if you have any questions.

## Introduction

## II. The client's rights to information from the bank

### What are the client's rights to information from the bank?

According to the Liechtenstein Banking Ordinance, banks are required to provide their clients with a general description of the type and risks of the financial instruments before carrying out services. This description must contain the characteristics of the type of financial instrument concerned as well as the associated risks in sufficient detail. Accordingly, this information brochure discusses customary product characteristics and explains the various financial instruments and their associated risks in a general way. The brochure does not provide information on the risks associated with specific individual financial instruments. The risk arising from the creditworthiness of the issuer of a product always depends on the specific case, and the investor must therefore pay particular attention to such credit risks. The risks of a particular product are thus ultimately always determined by its specific composition. The description below cannot replace the product descriptions by the issuers or a detailed examination of the specific product by the investor.

### Product descriptions by the issuers of financial instruments

Financial instruments offered to the public are subject to the prospectus requirement. Prospectuses may be requested directly from the issuer. Some are also available on the internet. As a rule, the issuer also offers "term sheets" summarising the essential information on the financial instruments in question, in particular on the specific risks and any guarantors. Your bank is happy to provide you with such documents where available.

### Taxation and other legal consequences

Investments in financial instruments may have tax consequences that diminish returns. The purchase, holding, or sale of financial instruments may also be subject to tax rules (e.g. withholding tax) outside the investor's country of domicile. This information brochure does not discuss taxes or their effect on your

personal tax situation, nor does it discuss other legal consequences pertaining to securities transactions (e.g. duties of disclosure). We advise you to look into these matters yourself or to obtain professional advice.

# Section One:

## General risks associated with investments in financial instruments

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### I. General risks associated with financial instruments

#### **Issuer risk (credit risk)**

Credit risk is determined by the borrower's credit capacity and creditworthiness and is therefore a measure of the borrower's solvency. The issuer risk is the danger of the insolvency of the borrower, i.e. the borrower's potential inability to fulfil obligations in a timely or complete manner, such as dividend payments, interest rate payments, repayment, etc. This risk can be estimated with the help of ratings, a scale for evaluating the solvency of the borrower. The rating is published by the recognised rating agencies, ranging from "AAA" (best credit rating) to "D" (worst credit rating). The higher the credit risk, the lower the corresponding rating and, as a rule, the higher the interest rate (risk premium) paid on a financial instrument. A deterioration of solvency or the complete insolvency of the borrower entails at least a partial loss of the invested capital.

#### **Settlement risk**

A settlement risk occurs when you have to pay the purchase price of a financial instrument in advance but receive the security with a time delay. In this event, the risk is that you will pay the purchase price and receive the securities late or even not at all. Conversely, when you are obliged to deliver financial securities that you have sold, you may not receive the purchase price from the buyer at the same time. Settlement risks mainly occur in emerging markets (see page 34).

#### **Guarantor risk**

Where a third party acts as the guarantor of an issuer, the insolvency of the guarantor may make timely settlement impossible (see also issuer risk).

#### **Inflation risk / monetary value risk**

Inflation may diminish the value of an investment. The purchasing power of the invested capital decreases when the inflation rate is higher than the return generated by the securities.

#### **Market risk / price fluctuation risk**

The market risk or price fluctuation risk is the potential fluctuation in the value of a financial instrument. If the market value of the financial instrument drops, the assets shrink.

#### **Country risk / transfer risk**

Investments abroad are subject to country risk. Insecure political, economic, and social circumstances in another country may have negative effects on all borrowers situated in that country. Country risk manifests itself financially mainly in the form of exchange rate risks and transfer risk, which may impede or entirely prevent the international movement of payments or capital. The latter may occur in the form of foreign exchange controls, capital movement restrictions, debt restructuring, and – in extreme cases – the "freezing" of accounts of foreign business partners.

There is also a risk that political or foreign exchange measures may prevent or aggravate the realisation of investments or the payment of interest and dividends. Problems may also occur when settling orders. In the case of foreign currency transactions, such measures may also entail that the foreign currency is no longer freely convertible.

#### **Liquidity risk**

The possibility of purchasing or selling a financial instrument at any time at prices in line with the market is called "liquidity". In the case of liquid financial

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instruments, sufficient supply and demand generally exist for the transaction to be concluded immediately. In the case of illiquid securities, supply or demand may be insufficient or non-existent, so that the purchase or sale may not be possible at the desired time and / or the desired price. Especially in the case of shares of unlisted companies or small companies (secondary stocks), structured products, issue of own securities, alternative investments, or investments with sales restrictions, it should be expected that the market may experience (phases of) illiquidity.

### Currency risk

If an investment in a financial instrument is carried out in a foreign currency, the return or performance of this transaction depends heavily on the development of the exchange rate of the foreign currency in relation to the base currency of the investor (e.g. Swiss franc). Sinking exchange rates lead to a diminishment in the value of the foreign currency investment. Investors only investing in their own country's currency can exclude this risk. However, internationally operating companies are more or less heavily exposed to exchange rate fluctuations. These fluctuations may therefore indirectly also affect the market value of financial instruments.

### Interest rate risk

Fluctuations in the interest rate level of money and capital markets directly affect the values of fixed-interest securities. As a rule, rising interest rates have a negative impact on the market values of equity papers and bonds. Sinking rates, conversely, have a positive effect on market values.

## II. Other general risks

### Purchase of financial instruments on credit ("leveraging")

The purchase of financial instruments on credit represents an increased risk. The borrowed funds must be repaid irrespective of the investment's success. The costs for taking out the loan also diminish the return.

### Risks in order placement

Order placement is the request by a client for his bank to buy or sell financial instruments. Buy or sell orders must at least indicate the number / par value of which financial instruments are to be bought or sold at what price.

- Market order

By marking "market order" (without limit price) on the order, you accept any possible price; the buy price or sell price is uncertain. Market orders are customarily processed immediately or in accordance with the practice of the trading centre.

Orders may include provisions to limit risk, which may however also increase the risk of non-execution.

- Limit price

With a "buy limit", you can limit the buy price of an order and thus your capital invested (upper limit price); i.e., no purchases will be carried out above the limit price. With a "sell limit", you can specify the lowest acceptable sell price (lower limit price); i.e. no sales will be carried out below the limit price.

- Time limit

You can limit the validity of an order with a time limit. The validity of orders without time limits is generally based on the practices of the trading centre used.

Your relationship manager will be happy to provide you with information on other order restrictions.

### Risks associated with custody of financial instruments

Financial instruments are generally held where they are most often traded (in your country or abroad). They are governed by the regulations that apply there. If your bank becomes insolvent, Liechtenstein law stipulates that the financial instruments deposited with that bank will not form part of its bankruptcy assets, but will be kept separate for your benefit. However, insolvency proceedings can delay the transfer of the financial instruments to you or another bank. If a third-party custodian becomes insolvent, the law in many



countries provides that the financial instruments deposited with that custodian by your bank are also normally protected. In less advanced markets (see page 34), however, financial instruments deposited with a third-party custodian in the country concerned may be included in the custodian's bankruptcy assets.

require all shareholders and creditors to assume full liability.

### **III. Risk of total loss and unlimited risks**

There are basically two types of financial instruments: those with limited risk and those with unlimited risk. With the purchase of financial instruments without margin calls, you assume a limited risk and, at worst, may lose the entire amount of your invested capital (total loss).

On the other hand, there are certain financial instruments that can require an additional outlay of capital over and above the original investment. The margin call may amount to many times the purchase price of the investment and, in theory, be unlimited.

In the event of the insolvency of an issuer (e.g. the issuer becomes overindebted or is unable to meet its payment obligations), the value of financial instruments issued by that issuer will decline significantly (potentially resulting in a total loss of the capital invested). As a general rule, insolvency administrators or government agencies will be appointed, and they will determine whether the undertaking can be continued or must be wound up under recovery and resolution procedures. The issuer's shareholders and creditors will either receive just a proportion of their claims, calculated on the basis of the liquidation assets, or will have the opportunity to hold an interest in the undertaking if it continues to operate. This ordinarily involves significant downgrading of shareholder or creditor claims and a substantial reduction in the nominal value of shares or a deterioration in the value of creditor claims. Shareholders or creditors are at risk of being bailed in under a bail-in regime, even if, in practice, losses must first be absorbed by other shareholders or creditors. Ultimately, this would

## Section Two

# Section Two:

## Overview of the characteristics and product-specific risks of financial instruments

### I. Bonds

#### What are bonds?

Bonds are securities for which the issuer (= borrower) is obliged to pay interest on the capital received from the bearer (= creditor, buyer) and to repay the capital in accordance with the agreed conditions (interest rate, issue price, maturity, denomination, repayment conditions, paying agent, guarantees, etc.).

#### What are the most common types?

- Medium-term bank notes  
Medium-term bank notes are medium-term, fixed-interest debt instruments issued on an ongoing basis according to the needs of the issuing bank.
- Straight bonds  
Straight bonds are issued by governments or private companies in return for cash. They are long-term partial debt instruments issued in round amounts.
- Eurobonds  
Eurobonds are bonds with medium and long durations (between 5 and 15 years) on the Euro-market, which unlike foreign bonds do not correspond to the currency of the placement country. Eurobonds are generally issued by international bank consortia. The borrowers are private companies, governments and other public bodies as well as supranational institutions.

**PLEASE NOTE:** "Eurobond" does not refer to the currency, but only means that the bond borrower is domiciled outside the country in which the bond is issued. A Eurobond may therefore be issued in dollars or francs, for instance. The predominant bond

currencies are US dollar, yen, Swiss franc, pound sterling and euro.

- Notes  
Notes are privately placed, securitised, medium-term debt instruments of foreign borrowers.

**PLEASE NOTE:** Private placement means that the securities are not traded on an exchange or a regulated market, but rather are only made available to a restricted circle of investors, which increases the liquidity risk.

- Convertible bonds / exchangeable bonds  
These are bonds that can be converted / exchanged into equity papers (e.g. shares) of the same company (convertible bonds) or of another company (exchangeable bonds), under certain prerequisites and conditions. If no conversion occurs, the bonds are paid back upon maturity at the par value or in accordance with the terms of the issue.
- Warrant issues  
Warrant issues are bonds giving the owner the right to buy a security (e.g. shares) traded on a regulated market within a certain time at a fixed price, in exchange for the warrant. This security (underlying) can be bought in addition to the bond. These warrants can also be traded independently of the bond.
- Mortgage bonds  
Mortgage bonds are straight bonds issued by specially authorised mortgage bond institutes, with special repayment and interest payment guarantees. The mortgage bond is secured directly by a lien on

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outstanding accounts and indirectly by a lien on property.

### How are bonds traded?

Bonds are traded on an exchange or regulated market or over-the-counter. Upon request, your bank can provide you with the buy and sell prices of specific bonds.

### What are the earnings and return expectations?

The earnings consist of the interest paid on the invested capital and any difference between the buy price and the price obtained when the bond is sold (e.g. issue price is less than redemption price) or upon maturity.

**PLEASE NOTE:** Any return can only be stated in advance if the bond is held until the regular repayment date. If the bond is sold before the regular repayment date, the achievable sell price is uncertain and depends on supply and demand, i.e. the effective return may differ from the originally calculated return. The calculation of the net return should also take account of fees.

### What are the particular risks?

- Issuer risk / credit risk
- Inflation risk / monetary value risk
- Market risk / price fluctuation risk
- Liquidity risk
- Currency risk (in the case of foreign currency bonds)
- Interest rate risk

## II. Money market instruments

### What are money market instruments?

"Money market instruments" designate financial instruments which, on the basis of their maturity and circle of issuers and investors, can be attributed to the money market. Financial instruments are attributed to the money market if their maturity does not exceed 12 months.

### What are the most common types?

The most common money market instruments include:

- Certificates of deposit  
Money market papers with maturities of generally 30 to 360 days, issued by banks.
- Commercial papers  
Short-term borrower's notes with maturities of generally 5 to 270 days, issued by large corporations.
- Treasury bills  
Short-term pecuniary claim against a state (especially USA, Canada, UK).

### How are money market instruments traded?

Typically, there is no regulated secondary market for money market instruments, i.e. they are not traded on an exchange or regulated market.

### What are the earnings and return expectations?

The earnings and return expectations are largely equivalent to those of bonds (see page 11).

### What are the particular risks?

Like the earnings and return expectations, the risk components of money market instruments largely correspond to those of bonds. Money market instruments have special liquidity risks, however. Since there is no secondary market, availability cannot be ensured at all times. The liquidity risk recedes if a sufficiently solvent issuer guarantees repayment of the invested capital at any time. Due to the short maturity, the interest rate sensitivity of these instruments is lower than that of bonds.

## III. Shares

### What are shares?

Shares are securities that securitise participation in a (joint stock) company.

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### What are the most common types?

- Classification according to transferability

Bearer shares are easily tradable, since the transfer of rights occurs with the transfer of the security. The shareholder remains unknown to the company. For this reason, bearer shares must always be fully paid-up.

In the case of registered shares, shareholders are entered in a share register. Only persons entered in the register are recognised as shareholders. Registered shares with restricted transferability are shares whose transferability is limited by the articles of incorporation.

- Classification according to rights

Preference shares or preferred shares enjoy certain privileges relating to dividends, subscription rights, and liquidation proceeds compared with ordinary shares. Often, however, these privileges are in exchange for a renunciation of voting rights. Ordinary shares are also called common stock.

Voting shares are a particular type of preference shares. These are shares with a lower par value than other shares of the same company, but with the same voting rights. Voting shares also exist with the same par value but greater voting rights.

Companies may also issue stock-like securities. These participation certificates and dividend-right certificates grant owners certain property or other rights defined in the articles.

### How are shares traded?

Shares can be traded on an exchange or regulated market as well as over-the-counter.

### What are the earnings and return expectations?

Share earnings can be composed of dividend payments, proceeds from subscription rights, and price gains / losses, so that they cannot be predicted.

A dividend is a proportion of the company profit distributed by resolution of the general meeting. In

exceptional cases, a dividend may also be distributed even though the company has not generated a profit. The amount of the dividend is either indicated as an absolute amount per share or as a percentage of the par value. Shares thus allow shareholders to participate directly in the economic success or failure of a company.

As a rule, the more substantial part of the earnings from shares consists in the performance (price development) of the share.

### What are the specific rights and duties?

Capital and membership rights can be distinguished.

- Membership rights in the general meeting of the company:

These include the right of participation, voting rights, the right to elect and stand for election, rights of control, and the right to contest resolutions.

- Capital rights:

Capital rights primarily include the right to a dividend, the right to subscribe for new shares during capital increases (subscription rights), and the right to part of the liquidation proceeds.

### What are the particular risks?

- Issuer risk / credit risk
- Country risk / transfer risk
- Liquidity risk
- Market risk / price fluctuation risk
- Currency risk

## IV. Investment funds

### What are investment funds?

An investment fund is a pool of assets, established as a separate legal entity, in which investors hold shares under an agreement with identical content concluded between a number of investors, thereby establishing a management company and a depository for the purposes of investing, managing and holding the collective assets in safekeeping on behalf of investors. Unless otherwise specified, the fund assets are

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managed by a management company for collective investment on behalf of investors in accordance with the investment strategy and the principle of risk-spreading. Capital invested by multiple investors is therefore pooled in the investment fund and reinvested. Securities funds and non-securities funds are subcategories of investment funds.

First of all, it is necessary to draw a distinction between investment funds in terms of their governing law:

- Foreign investment funds governed by foreign statutory provisions, which may vary significantly from the laws and regulations applying in Liechtenstein
- Liechtenstein investment funds governed by Liechtenstein law, which are described in more detail below

### Investment funds under Liechtenstein law

Liechtenstein investment funds are governed by a number of different laws. The EU UCITS IV Directive was transposed into national law by means of the Liechtenstein Act on Certain Undertakings for Collective Investment in Transferable Securities (UCITS Act; *Gesetz über bestimmte Organismen für gemeinsame Anlagen in Wertpapieren – UCITSG*) and the related Liechtenstein Ordinance on Certain Undertakings for Collective Investment in Transferable Securities (UCITS Ordinance; *Verordnung über bestimmte Organismen für gemeinsame Anlagen in Wertpapieren – UCITSV*). In comparison, the following two pieces of legislation apply to non-securities funds:

- Liechtenstein Alternative Investment Fund Managers Act (AIFM Act; *Gesetz über die Verwalter alternativer Investmentfonds – AIFMG*) and the related Liechtenstein Ordinance on Alternative Investment Fund Managers (AIFM Ordinance; *Verordnung über die Verwalter alternativer Investmentfonds – AIFMV*)
- Liechtenstein Investment Undertakings Act (IUA; *Investmentunternehmensgesetz – IUG*) and the

related Liechtenstein Investment Undertakings Ordinance (IUO; *Investmentunternehmensverordnung – IUV*).

### What types of investment fund are there?

The law distinguishes between the following fund types, based on the type of investment:

- Undertakings for collective investment in transferable securities (UCITS)  
Since 2011, undertakings for collective investment in transferable securities (UCITS or UCITS funds) have been governed by the UCITS Act. The Act sets out the rules and procedures for the licensing, supervision and investment activities of investment funds and related management companies. The Act applies to all UCITS that are established in Liechtenstein or available to the general public either in or from Liechtenstein. Because the Principality of Liechtenstein is a member of the EEA, Liechtenstein management companies and related UCITS funds benefit from EU passporting rights, providing direct access to the European market. The sole object of UCITS is the collective investment of capital raised from the public in transferable securities or in other liquid financial assets referred to in the UCITS Act by operating on the principle of risk-spreading with units which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of such undertakings' assets. Action taken by a UCITS to ensure that the stock exchange value of its units does not significantly vary from their net asset value are regarded as equivalent to such repurchase or redemption. The management company may be constituted in accordance with contract law (as an investment fund managed by a management company), trust law (as unit trusts or collective trusts) or under articles of association (as an investment company). Investment companies must be set up as a public limited company with variable or fixed capital.
- Alternative investment funds (AIFs)  
The AIFM Act applies to all AIF managers of all types of fund that either qualify as a UCITS, within the meaning of the UCITS Act, or as an investment

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undertaking, within the meaning of the IUA, irrespective of whether they are constituted under contract law or have any other legal form. Unlike the approach in the UCITS Act, which focuses on the fund product, the AIFM Act is centred around the fund manager (AIFM). The AIFM is responsible for ensuring compliance with regulatory requirements. There are four types of AIF as follows:

### (1) AIF for liquid assets

AIFs for liquid assets have at least 70 % of their net asset value (NAV) invested in liquid assets.

### (2) AIFs for illiquid assets

AIFs for illiquid assets have at least 70 % of their NAV invested in illiquid assets.

### (3) Flex funds

A flex fund is an AIF that can invest in a mixture of liquid and illiquid assets under its investment policy. Details of the investment policy must be set out in the constitutive documents.

### (4) Leveraged AIFs

Leveraged AIFs are AIFs in which the AIFM is permitted to employ leverage exceeding three times the NAV in accordance with the applicable provisions of the AIFM Ordinance.

### • Investment undertakings (IUs)

An IU means any undertaking for collective investment, including segments thereof, that does not qualify as a UCITS under the UCITS Act or as an AIF under the AIFM Act, is intended solely for qualified investors and does not raise capital (or distribute units). The IUA defines four categories of IU, i.e. IUs for single investors, IUs for families, IUs for interest groups and IUs for affiliated groups:

#### (1) IUs for single investors

IUs that are intended solely for individual qualified investors, as specified in the prospectus, do not invest assets which they have raised from more than one legal entity or individual with a view to investing them for the benefit of those persons, and does not consist of

an institution or structure which in total has more than one investor.

#### (2) IUs for families

IUs set up for the sole purpose of investing the assets of members of a family, irrespective of the type of legal structure involved, where the only investors are members of the family.

#### (3) IUs for interest groups

IUs set up for the sole purpose of investing the assets of certain, qualified investors within the interest group, irrespective of the type of legal structure involved, where the only investors are members of the interest group.

#### (4) IUs for affiliated groups

IUs set up for the sole purpose of investing the assets of the relevant group undertakings, irrespective of the type of legal structure that may be put in place by them, where the only investors are group undertakings.

**PLEASE NOTE:** The categories set out above only apply to Liechtenstein investment funds. Foreign investment funds may be assigned to different categories.

**PLEASE NOTE:** Hedge funds are high-risk investment vehicles. Please read the information set out in the "Alternative (non-traditional) investments" section on page 28.

### How are investment fund units traded?

Investment fund units may be acquired and redeemed directly from the management company or AIFM concerned and / or traded on a stock exchange or regulated market.

The units of investment funds with variable capital (open-ended funds) can, in principle, be redeemed at net asset value (market value) at any time. Unit certificates are issued on a regular basis. Redemptions may be restricted in exceptional circumstances, as defined in the prospectus.



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**PLEASE NOTE:** Capital deposited in investment funds with fixed capital (closed-ended funds) is invested in specific investments. The number of unit certificates is defined in advance. It is important to note that, in certain circumstances, it may not be possible to redeem the units of such investment funds (e.g. SICAFs) at any time.

### What are the potential earnings or returns?

The earnings generated from investment funds consist in annual distributions (unless the fund is a capital appreciation fund that reinvests earnings rather than distributing them) and any gain in the calculated net asset value for the investment fund. Earnings cannot be determined in advance.

Performance will depend on the investment policy set out in the prospectus and how the markets perform for the individual assets comprising the investment fund.

**PLEASE NOTE:** Depending on the composition of the investment fund, any special risk indications should be duly noted.

### Where can key information on specific investment funds be found?

A full prospectus must be prepared for each investment fund, allowing investors to evaluate the proposed investments in detail and assess the level of risk involved.

Key investor information must also be prepared for each investment fund, summarising the information contained in the full prospectus. This should set out the most important information in a clear and readily understandable manner that allows investors, for example, to assess the investment policy, and contain an explanation of the fund's risk profile.

### What is special about investment fund units?

The term to maturity of an investment fund is defined in the prospectus, and funds are generally established for an unlimited period of time. Although it is normally possible to redeem units at any time,

investment funds are investment products that typically only make economic sense if capital is invested over a longer time horizon (with the exception of money market funds).

### What are the risks involved?

Risks will vary depending on the investment strategy deployed by the investment fund. The main risks are as follows:

- Issuer risk / credit risk
- Inflation risk / monetary value risk
- Liquidity risk
- Market risk / price risk
- Currency risk

## V. Derivatives / Forwards and futures

### What are derivatives?

Derivatives are futures contracts, the value of which depends on the development of one or more underlying variables. The basic forms of derivative products include:

- options (see page 15)
- forwards (see page 20)
- futures (see page 20)
- swaps (see page 23)

Other possible derivative products include:

- structured products (see page 24)
- products for financing or risk transfer purposes (see page 27)

## 1. Options

### What are options?

Options in principle give the buyer the right, but not the obligation, to make use of an offer. In the financial sector, options are derivative financial products, i.e. their value is derived from an underlying assets (often simply referred to as the "underlying"). The price of an option is closely linked to that of the underlying asset. Any change in the market value of the underlying asset will result in a greater change in the price of the option (leverage effect). This allows disproportionate parti-

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icipation in any rise or fall of the market value of the underlying asset.

### How are the different types of options traded?

- Warrants are options in securitised form that are traded on an exchange or over the counter.
- Exchange-traded options are standardised contracts that are non-securitised, but are traded on an exchange or a regulated market.
- OTC (over-the-counter) options are neither securitised nor traded on an exchange or a regulated market. They are agreed directly off-exchange between the writer and the buyer. Cancelling (closing out) an option before the expiration date requires a corresponding offsetting trade between the same parties. OTC options with precious metals and currencies as their underlying are offered publicly as standardised products. Tailor-made OTC options, by contrast, are specially created for individual investors.

### What are your rights and duties?

As the buyer of an option, you have the right to buy a specified amount of an underlying asset from the seller (call option) or sell it to him / her (put option) at a predefined price (strike price) up until a set time (expiration date). The price you pay for this right is called the premium.

As the seller (writer, covered writer) of an option, you must sell the underlying to the buyer at the strike price (call option) or buy the underlying from him / her at the strike price (put option) up until the expiration date, irrespective of the market value of the underlying asset at the time, if he / she chooses to exercise the option. As the seller of an option, you receive the premium.

### What are "American-style" and "European-style" options?

"American-style" options can normally be exercised on any trading day up to the expiration date. "European-style" options can only be exercised on the expiration date, in other words the date set out in the contract.

This does not, however, normally affect their tradability on the secondary market (e.g. on a stock exchange or regulated market).

### What underlying assets can options be based on?

The commonest underlying assets for options are:

- assets such as Shares, bonds, commodities (e.g. precious metals);
- benchmark rates such as currencies, interest rates, and indices;
- derivatives; and
- any combination of the above.

### What is "physical settlement"?

Where a call option provides for "physical settlement", you can require the counterparty (the writer of the option) to deliver the underlying asset when you exercise the option. With a put option, the writer is obliged to buy the underlying asset from you.

### What is "cash settlement"?

If an option provides for "cash settlement", you are only entitled to a sum of money corresponding to the difference between the strike price and the applicable market value of the underlying asset on the expiration date of the option.

### What do "in the money", "out of the money" and "at the money" mean?

A call option is "in the money" if the current market value of the underlying asset is above the strike price. A put option is in the money if the current market value of the underlying asset is below the strike price. An option that is "in the money" is said to have an "intrinsic value".

A call option is "out of the money" if the current market value of the underlying asset is below the strike price. A put option is "out of the money" if the current market value of the underlying asset is above the strike price. In this case, the option has no intrinsic value.

If the current market value of the underlying asset is the same as the strike price, the option is "at the money". In this case, it has no "intrinsic value".



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### What determines the price of an option?

The price of an option depends on its intrinsic value and on the time value.

The intrinsic value is the positive difference between the current market value of the underlying asset and the lower strike price for call options / the higher strike price for put options.

The time value depends on a variety of factors, including the remaining life of the option and the volatility of the underlying. The time value reflects the difference between the intrinsic value of the option and the current price of the option and corresponds to the amount that a buyer is willing to pay, in light of the chances of an option. It is therefore higher for options with a long duration and a very volatile underlying and for options that are at the money.

### What is margin cover?

As the writer (seller) of an option, you have to deposit either an amount of the underlying asset or another form of collateral for the entire duration of the contract. The level of this collateral (margin) is determined by the bank. The bank or regulated market stipulates a minimum margin for traded options.

**PLEASE NOTE:** If the margin cover proves insufficient, the bank can require you provide additional collateral (via a "margin call", see page 9).

### What risks do you face as the buyer of an option?

Generally speaking, if the market value of the underlying asset falls, so does the value of your call option. The value of your put option tends to fall if the underlying asset rises in value. Normally, the less your option is in the money, the larger the fall in the option's value. In such cases, value reduction normally accelerates close to the expiration date.

The value of your call option can drop even when the value of the underlying remains unchanged or rises. This can happen as the time value of your option falls or if supply and demand factors are unfavourable. Put options behave in precisely the opposite manner.

**PLEASE NOTE:** You must therefore be prepared for a potential loss in the value of your option, or for it to expire entirely without value. In such a scenario, you risk losing the whole of the premium you paid.

### What risks do you face as the writer (seller) of a covered call option?

If, as writer of a call option, you already have a corresponding quantity of the underlying at your disposal, the call option is described as covered. If the current market value of the underlying exceeds the strike price, your opportunity to make a profit is lost since you must deliver the underlying to the buyer at the strike price, rather than selling the underlying at the (higher) market value. You must have the underlying assets freely available as long as it is possible to exercise the option, i.e. they may not, for example, be blocked by being pledged for other purposes (such as for a Lombard loan). Otherwise, you are essentially subject to the same risks as when writing an uncovered call option (see below).

### What risks do you face as the writer (seller) of an uncovered call option?

If, as the writer of a call option, you do not have a corresponding quantity of the underlying at your disposal, the call option is described as uncovered. In the case of options with physical settlement, your potential loss amounts to the price difference between the strike price paid by the buyer and the price you must pay to acquire the underlying assets concerned. Options with cash settlement can incur a loss amounting to the difference between the strike price and the market value of the underlying.

**PLEASE NOTE:** Since the market value of the underlying can move well above the strike price, your potential loss cannot be determined and is theoretically unlimited.

As far as American-style options in particular are concerned, you must also be prepared for the fact that the option may be exercised at a highly unfavourable time when the markets are against you. If you are then obliged to make physical settlement, it may be very

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expensive or even impossible to acquire the corresponding underlying assets.

You must be aware that your potential losses can be far greater than the value of the underlying assets you lodged as collateral (margin cover) either when entering into the contract or thereafter.

### What risks do you face as the writer (seller) of a put option?

As the writer of a put option, you must be prepared for potentially substantial losses if the market value of the underlying falls below the strike price you have to pay to the seller. Your potential loss corresponds to the difference between these two values (minus the premium received).

As the writer (seller) of an American-style put option with physical settlement, you are obliged to accept the underlying assets at the strike price, even though it may be difficult or impossible to sell the assets and may well entail substantial losses.

**PLEASE NOTE:** Your potential losses can be far greater than the value of any underlying assets you may have lodged as collateral (margin cover). You could in a worst case lose your entire capital invested.

### What are option strategies?

If you acquire two or more options, based on the same underlying, which differ in either the option type (call or put), the quantity, the strike price, the expiration date or the type of position (long or short), this is referred to as an option strategy or combination.

**PLEASE NOTE:** Given the large number of possible combinations, we cannot go into detail here about the risks involved in any particular case. Before entering into any such transaction, be sure to consult your bank about the particular risks involved.

### What are exotic options?

Unlike the "plain vanilla" put and call options described above, exotic options are linked to additional conditions and agreements. Exotic options come in the form of tailor-made OTC options or as warrants.

Given the special composition of exotic options, their price movements can vary markedly from those of their "plain vanilla" cousins.

**PLEASE NOTE:** You must also be aware that larger transactions can trigger price movements even shortly before expiration and that these can render an option worthless. There is no limit to the possible structures for exotic options. We cannot describe in full here the risks involved in any particular case. Before buying any exotic options, be sure to seek comprehensive advice about the particular risks involved.

The examples of exotic options listed below can be broadly divided into two categories: path-dependent options and options on more than one underlying.

### What are path-dependent options?

Unlike "plain vanilla" options, for path-dependent options, it is not just when the option expires or is exercised that the market value of the underlying is important. You also need to take into account fluctuations in the market value of the underlying during the life of the option when contemplating such an investment. The following are examples of path-dependent options:

- Barrier options  
Your exercise rights for knock-in barrier options only arise if the market value of the underlying reaches a fixed threshold (barrier) within a specified period. Exercise rights for knock-out barrier options expire if the market value of the underlying reaches the specified barrier during the given time period.

If this barrier is between the market value of the underlying at the time the option was entered into and its strike price, it is referred to as a kick-in / kick-out barrier option.

Double-barrier options have both an upper and a lower barrier and may take the form of knock-in and knock-out barrier options.

**PLEASE NOTE:** When buying a barrier option, you must be aware that your exercise rights only arise

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when the market value of the underlying reaches the barrier ("knock-in" / "kick-in" option) or that they expire irrevocably when that barrier is reached ("knock-out" / "kick-out" option).

- Payout options

Payout options accord you the right to payment of a fixed amount agreed in advance.

In the case of a digital (otherwise known as "binary") option, you receive payment if the market value of the underlying reaches a fixed value once during a specified time period (one-touch digital option) or precisely on the day of expiration (all-or-nothing option). For the one-touch digital option, payment occurs either immediately once the barrier is reached or on the date of expiration (lock-in option).

With lock-out options, you only receive the fixed payment if the market value of the underlying does not reach the agreed barrier during a specified time period.

**PLEASE NOTE:** As the writer (seller) of a payout option you owe the full fixed amount if the barrier is reached, regardless of whether or not the option is in the money when exercised or on the expiration date, or to what extent. This means that the amount you owe can be considerably larger than the option's intrinsic value.

- Asian options

For Asian options, an average value is derived from the market value of the underlying over a specified time period. This average is used to determine the underlying's value for an average-rate option and to calculate the strike price for an average-strike option.

**PLEASE NOTE:** The calculation of an average value for the underlying in the case of the average-rate option can result in the value of the option on the expiration date being considerably lower for the buyer and considerably higher for the writer than the difference between the strike price and the current market value on expiry.

**PLEASE NOTE:** For an average-strike option, the average strike price of a call option can be considerably higher than the price originally set. For an equivalent put option, the strike price can similarly be lower than the price originally set.

- Lookback options

With a lookback option, the market value of the underlying is recorded periodically over a specified time period.

For a strike-lookback option the lowest value (call option) or the highest value (put option) of the underlying becomes the strike price.

The strike price remains unchanged for a price-lookback option, with the highest value (call option) / lowest value (put option) being used in calculating the option value of the underlying.

**PLEASE NOTE:** For lookback options, both the calculated strike price and the calculated value of the underlying can vary considerably from the market prices prevailing on the expiration date. As the writer (seller) of an option of this type, you must be aware that it will always be exercised at the most unfavourable value for you.

- Contingent options

When you buy a contingent option you must pay the premium only if the market value of the underlying reaches or exceeds the strike price during the life of the option ("American-style" option) or on the expiration date ("European-style" option).

**PLEASE NOTE:** You will have to pay the entire premium even if the option is only just at the money or just in the money.

- Cliquet and ladder options

For cliquet options (also known as ratchet options), the strike price is modified for the following period, normally at regular intervals, in line with the market value of the underlying. Any intrinsic value of the option is locked in. All "lock-ins" arising over the entire life of the option are accumulated.

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For ladder options, these modifications take place when the underlying reaches specified market prices, rather than at regular intervals. Normally, only the highest intrinsic value is locked in. In rare cases, all the intrinsic values recorded are added together.

**PLEASE NOTE:** As the writer (seller) of a cliquet option, you are required on the expiration date to pay the buyer all the accumulated lock-ins in addition to any intrinsic value of the option. If you sell a ladder option you must pay the buyer the highest lock-in amount, which can be considerably higher than the option's intrinsic value on the expiration date.

### What are options on more than one underlying?

Examples of options on more than one underlying are:

- Spread and outperformance options

Both spread and outperformance options are based on two underlyings. With a spread option, the absolute difference in movement between the two underlyings forms the basis for calculating the option's value. By contrast, the value of an outperformance option is based on the relative difference, i.e. the percentage outperformance of one underlying compared to the other.

**PLEASE NOTE:** Even if the underlying performs positively, the difference between the underlyings may be equal or lower in absolute as well as relative terms, thus having a negative impact on the value of the option.

- Compound options

The Compound options have an option as their underlying, i.e. they are options on options.

**PLEASE NOTE:** Compound options have an especially large leverage effect. As a writer (seller) of an option of this type, you can be faced with very substantial obligations.

- Credit default options

With a credit default option, a credit risk of the original risk-taker (risk seller) is transferred to a third

party (risk buyer), who receives a premium in return. If the defined credit event occurs, the risk buyer is obliged to effect a cash settlement or take on the non-performing loan (or another delivery obligation) by way of physical settlement at a previously determined price. Credit default options are a form of credit derivatives.

**PLEASE NOTE:** The risk of chain reactions on the credit market is high and can easily be underestimated. There is also the risk that lack of liquidity will lead to price distortions when volumes are low. This may mean that the investment can only be sold at a low price, longer term or even not at all.

## 2. Forwards and futures

### What are forwards and futures?

Forwards are transactions in foreign currency, money market, and precious metal trading, for which delivery and payment take place on a specified date in the future. All conditions (scope of the contract, price, duration, beginning of the contract) are already negotiated at the time the contract is concluded. Forwards are not traded on an exchange or regulated market; hence they are referred to as OTC (over-the-counter) forwards. Their specifications may also be standardised; otherwise they may be individually agreed between the buyer and the seller.

Futures are traded on an exchange. They grant the right / duty to buy / deliver specified financial instruments at a specified due date and at a specified price. They take the form of contracts in which the quantity of the underlying and the expiration date are standardised.

### What are your rights and duties?

With forwards and futures you undertake to deliver or take delivery of a defined quantity of an underlying on a specified expiration date at a price agreed on the contract date.

**PLEASE NOTE:** Forwards and futures involve special risks. You should therefore only make investments

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of this type if you are familiar with this type of instrument, have sufficient liquid assets and are able to absorb any losses that may arise.

### What underlying assets can forwards and futures be based on?

Underlyings for forwards and futures are:

- assets such as shares, bonds, commodities (e.g. precious metals), etc.
- benchmark rates such as currencies, interest rates, and indices

### What are the most common types of futures?

Futures can be distinguished according to the following types of underlyings:

- interest rate futures
- currency futures
- commodity futures

### What is a margin?

When you buy or sell (short) an underlying asset on the futures market, you must supply a specified "initial margin" when entering into the contract. This is usually a percentage of the total value of the contracted instruments. In addition, a "variation margin" is calculated periodically during the life of the contract. This corresponds to the book profit or loss arising from any change in value in the contract or underlying instrument. The way in which the variation margin is calculated will depend on the rules of the exchange concerned and / or the conditions of the contract.

As the investor, you are obliged to deposit the required initial and variation margin cover with the securities dealer for the entire life of the contract.

**PLEASE NOTE:** In the event of a book loss, the variation margin can be several times as large as the initial margin.

### How is a transaction closed out?

As the investor, you are entitled to close out the contract also at any time prior to the expiration date. How this is done depends on the type of contract or stock exchange practice. You either close out your

position or agree an offsetting trade with identical terms. Concluding such an offsetting trade means that the obligations to deliver and receive cancel one another out.

**PLEASE NOTE:** For standardised OTC forwards, the market is transparent and liquid. As a rule, such contracts can therefore be closed out at any time. For OTC forwards with individual conditions of the contract, no actual market exists. Such contracts can therefore only be closed out with the agreement of the counterparty.

### How is the transaction settled?

If you do not close out the contract prior to the expiration date, you and the counterparty must settle it.

If the underlying in your contract is a physical asset, settlement is achieved by physical delivery or a cash payment. Generally, the asset is physically delivered. Only in exceptional cases do the contract provisions or stock exchange practice call for cash settlement. All other fulfilment specifications, especially the definition of the place of fulfilment, can be found in the relevant contract provisions.

The difference between physical delivery and cash settlement is that with physical delivery, underlyings amounting to the entire contractual value must be delivered, whereas with cash settlement, only the difference between the agreed price and the market value on settlement needs to be paid. This means that you need more funds available for physical delivery than for cash settlement.

If the underlying in your contract is a reference rate or benchmark, fulfilment by physical delivery is not permitted (except for currencies). Instead, settlement is always in cash.

### What special risks do you need to bear in mind?

For forward sales, you must deliver the underlying at the price originally agreed even if its market value has since risen above the agreed price. In such a case, you risk losing the difference between these two amounts.



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**PLEASE NOTE:** Theoretically, there is no limit to how far the market value of the underlying can rise. Hence, your potential losses are similarly unlimited and can substantially exceed the margin requirements.

**PLEASE NOTE:** For forward purchases, you must take delivery of the underlying at the price originally agreed even if its market value has since fallen below the agreed price. Your potential loss corresponds to the difference between these two values. Your maximum loss therefore corresponds to the originally agreed price. Potential losses can substantially exceed the margin requirements.

In order to limit price fluctuations, an exchange or regulated market may set price limits for certain contracts. Find out what price limits are in place before effecting forward or futures transactions. This is important since closing out a contract can be much more difficult or even impossible if a price limit of this type is reached.

**PLEASE NOTE:** If you sell forward an underlying which you do not hold at the outset of the contract, this is referred to as a short sale. In this case, you risk having to acquire the underlying at an unfavourable market value in order to fulfil your obligation to effect delivery on the contract's expiration date. In the worst case, it may be impossible to obtain the underlyings due to the illiquidity of the market, so that you will be unable to fulfil your obligation to effect delivery.

### What special factors apply to combinations?

Since combinations comprise a number of elements, closing out individual elements can considerably alter the risks inherent in the overall position. Before entering into any such transaction, be sure to consult your bank about the particular risks involved.

## 3. Forward exchange contracts

### What are forward exchange contracts?

A forward exchange contract is a contractual agree-

ment between two parties to exchange two agreed currency amounts at a specified future date.

### How are forward exchange contracts settled?

Forward exchange contracts are regularly settled effectively. On the due date the contracting parties exchange the respective currency amounts as agreed. Delivery and receipt of the counter currency thus take place with the same value date.

### Can forward exchange contracts be terminated / closed out early?

There are two ways to terminate / close out forward exchange contracts early:

- by settling the contract early as a spot exchange transaction, where any arising interest costs are billed between the contracting parties, and
- by entering into a position counter to the original transaction.

### What is the use of forward exchange contracts?

Forward exchange contracts serve as forward cover. Using forward exchange contracts for hedging purposes means fixing an exchange rate so that the expenses or earnings of the hedged transaction are neither increased nor diminished by intervening exchange rate fluctuations. Forward exchange contracts also serve to protect foreign currency balances and foreign currency securities with short and medium maturities. Forward exchange contracts are also often used for speculation purposes.

### What special risks do you need to bear in mind?

As a seller in a foreign exchange contract, you undertake to deliver foreign currency at an agreed exchange rate. If the exchange rates rise, you will still have to delivery at the previously agreed price, which may be very substantially lower than the current exchange rate.

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**PLEASE NOTE:** Your potential loss as a seller may be far greater than the collateral provided, if you do not own the foreign currency as a seller but rather want to acquire the currency only at the due date. In this case, you may incur substantial losses, since – depending on the market situation – you may have to buy the currency at a very high price or pay compensation if you are unable to acquire the currency.

As a buyer, you undertake to purchase foreign currency at the agreed price, even if the exchange rate drops in such a way that the price is substantially higher than the current exchange rate.

**PLEASE NOTE:** Your potential loss as a buyer cannot be determined in advance and may be far greater than any collateral you may provide.

Transfer risk is of particular importance for forward exchange contracts. Through governmental measures, the transfer of currency or the conversion thereof into another currency may be prohibited.

### 4. Swaps

#### What are swaps?

A swap is an agreement to exchange payment streams. Swaps are mainly used to hedge certain assets against fluctuations due to changes in the interest rate level, currency ratios, or other risks. They may also be used to optimise earnings. Swaps are not traded on an exchange or en masse.

#### What are the most common types of swaps?

The most common and familiar swaps include interest rate swaps (IRS), currency swaps, and cross currency swaps (CCS).

- Interest rate swaps (IRS)

An interest rate swap governs the exchange of differently defined interest rate obligations on a fixed nominal amount between two contracting parties. As a rule, the swap concerns the exchange of fixed against variable interest payments. Thus, only

interest payments are exchanged, with no capital flow.

The buyer of the IRS makes a profit if the market interest rate level rises; the seller, if it drops. Neither can be determined in advance.

**PLEASE NOTE:** IRSs are not standardised. The settlement details must be contractually agreed in advance. They are customised products. It is therefore especially important to obtain information on the precise conditions.

- Currency swaps

A currency swap is the exchange of two currencies over a specified time period. The interest rate difference of the two involved currencies is taken into account by premiums and discounts in the re-exchange rate. Delivery and receipt of the counter currency take place with the same value date.

The earnings (profit / loss) for the user of currency swaps arise from the positive / negative development of the interest rate difference and may be generated during the term of the currency swap in the case of a counter transaction.

- Cross currency swaps (CCS)

A cross currency swap governs both the exchange of differently defined interests payable and of different currencies on a fixed nominal amount between two contracting parties. As a rule, a cross currency swap is an exchange of fixed interest payments in two different currencies. Both interest payments may of course also take place within variable interest obligations. The payment streams take place in different currencies on the basis of the same capital amount, which is fixed on the contract date at the applicable spot exchange rate.

In addition to the exchange of interests payable and interests receivable, a capital exchange takes place both at the beginning (initial exchange) and at the end (final exchange) of the term. Depending on the needs of the contracting parties, the initial exchange may be omitted.

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If the exchange rate and the interest rate difference develop positively, earnings may be generated when the CCS is cancelled early. Should the CCS be concluded to improve the interest rate difference, the lower interest rates in another currency may generate earnings. These earnings may, however, be offset by any currency losses. Should the currency ratio develop positively, the earnings may even be improved. Any earnings cannot be determined in advance, however.

**PLEASE NOTE:** CCSs are not standardised. These are also tailor-made products. Again, it is therefore especially important to obtain information on the precise conditions.

## VI. Structured products

### What are structured products?

Structured products are derivative financial instruments that may consist of several components.

Structured products are issued either publicly or privately. Their redemption value depends on the performance of one or more underlyings. They may have a fixed or unlimited term and consist of one or more components.

### What are the most common types of structured products?

Here is a list of the most common product categories, based on the categorisation model used by the Swiss Structured Products Association (SSPA):

- capital protection products (see page 25)
- yield enhancement products (see page 26)
- participation products (see page 26)
- leverage products (see page 27)

### How are structured products traded?

Structured products may be listed for trading on an exchange or regulated market, but do not have to be.

The tradability of a structured product depends on whether the issuer or a market maker is prepared to

make a price. Even if they are, liquidity risks can still arise. If the market is not liquid, you run the risk of having to either hold the financial instrument until the end of its term or sell it during the term at an unfavourable price.

It can also be difficult or impossible to determine a fair price or even compare prices at all, as there is often only one market maker.

### What special risks do you need to bear in mind?

Every structured product has its own risk profile, and the risks of its individual components may be reduced, eliminated or increased. In particular, it may profit to different degrees from rising, constant or falling market values of the underlying, depending on the product involved.

**PLEASE NOTE:** It is extremely important to find out exactly what the risks are before acquiring a product of this kind. This information can be found in, for example, the issue documents or the product description concerned.

### Are structured products covered by the regulation on investment funds?

Structured products are not categorised as investment funds according to the investment fund regulation. Unlike with collective investments, the issuer is liable with his or her own assets (as is any guarantor, to the extent of a guarantee they have provided), and there is no backing from specially protected assets. You therefore need to bear in mind that in addition to a potential loss resulting from a decline in the market value of the underlyings (market risk), you may in the worst case lose your entire investment because the issuer or guarantor becomes insolvent (issuer or guarantor risk).

### Do you have an entitlement to voting rights and dividends?

You do not normally have any entitlement to voting rights or dividends if you buy a structured product.



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### 1. Capital protection products

#### What types of capital protection are there?

Some structured products offer capital protection. The level of this protection is fixed by the issuer when the product is issued and indicates the percentage of the nominal value that will be repaid to the investor on expiration. However, capital protection generally only applies at the end of the term and may, depending on the product conditions, be (far) lower than 100 % of the invested capital.

**PLEASE NOTE:** Some structured products offer only conditional capital protection, which can be lost if the value touches, falls below or rises above a predefined threshold (barrier, "knock-out level"). Repayment is then dependent on the performance of one or more underlyings.

#### What are structured products with capital protection?

Structured products with capital protection consist of two elements, such as a fixed-income investment (especially a bond or a money market investment) and an option. This combination enables the holder to participate in the performance of one or more underlyings (via the option or participation component) while at the same time limiting potential losses (via the fixed-income investment or capital protection component). The capital protection component may only cover a portion of the capital invested.

#### What is the purpose of the capital protection component?

The capital protection component determines the minimum repayment you receive on expiration, regardless of how the participation component performs.

#### What does the capital protection relate to?

The capital protection is linked to the nominal value rather than the issue price or purchase price. Hence, if the issue / purchase price you pay exceeds the nominal value, only the nominal value is capital-protected. The protection of your capital outlay drops accordingly. If,

however, the issue / purchase price is less than the nominal value, the protection of your capital outlay rises accordingly.

#### Is the invested capital fully protected?

The capital protection component can be well under 100 % of the capital invested, depending on the product. Capital protection does not therefore mean 100 % repayment of nominal value or the purchase price for all products. Structured products with capital protection generally offer lower returns than direct investments in the underlying, as the capital protection costs money.

#### Does the capital protection still apply if you sell the product during its term?

**PLEASE NOTE:** If you wish to sell a structured product with capital protection before it expires, you may receive less than the capital protection component as the capital protection only applies until the end of the term.

#### What is the purpose of the participation component?

The participation component determines how you benefit from price movements in the underlying(s) when you buy a structured product. In other words, it fixes the level of your potential return over and above the capital protection component. Some structured products with capital protection offer only a limited potential participation (those with a cap); some (those without a cap) offer unlimited potential participation. Others require the market value of the underlying to touch, rise above or fall below a specific barrier before you can make a profit.

#### How high is the risk on the participation component?

The risk on the participation component is the same as that on the corresponding option or combination of options. Depending on the movements in the market value of the underlyings, the participation component may therefore be zero.

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### What is the maximum possible loss?

**PLEASE NOTE:** Your maximum loss on a structured product with capital protection is limited to the difference between the purchase price and the specified conditional or absolute capital protection, provided you continue to hold the product until expiration. You may also miss out on a profit due to the fact that full or partial repayment of the capital is guaranteed but no income (interest) is paid.

## 2. Yield enhancement products

### What are structured products with yield enhancement?

Structured products with yield enhancement consist of two elements, such as a fixed-income investment and an option (mainly on shares or currencies), and possibly a currency swap. This combination enables you to participate in the performance of one or more underlyings (via the option component). However, these financial instruments offer no or only conditional capital protection. The interest that is paid means you receive a higher return than with a direct investment if the price of the underlying remains essentially unchanged. On the other hand, you will not benefit from the full potential return of the underlying.

If the market value of the underlying rises, you will receive the stipulated interest and the nominal value on expiration (equally, the product may provide for a discount on the issue price). If the market value of the underlying rises sharply, you could possibly have earned a higher return on a direct investment. However, if the market value of the underlying falls sharply, you will receive both the interest payment and the underlying on expiration (unless the product offered a discount on the issue price).

### What special risks do you need to bear in mind?

Many products with yield enhancement provide that you as the investor receive the security with the worst performance on expiration (either physically or in the form of cash) if the underlying touches, rises above or

falls below a predefined barrier during the term of the financial instrument. If the performance of the underlying is negative, the financial instrument can trade some way below the issue price during its term even if the barrier is not touched, exceeded or undershot.

The level of interest rate is directly related to the level of the barrier. The nearer the barrier is to the market price of the underlying on the day of issue, the higher the interest you receive will generally be, but the higher the risk that the barrier will be reached, and vice versa.

### What is the maximum possible loss?

**PLEASE NOTE:** When you invest in a structured product with yield enhancement, you could in the worst case scenario lose the entire capital that you have invested.

## 3. Participation products

### What are structured products with participation?

Structured products with participation enable you to participate in the performance of one or more underlyings. However, they offer no or only conditional capital protection.

If the participation product offers conditional capital protection, the risk is smaller than with a direct investment provided the market value of the underlying does not reach a specific barrier (termed the "knock-out").

**PLEASE NOTE:** If the market value of the underlying touches, rises above or falls below the barrier, you will lose the capital protection.

### What special risks do you need to bear in mind?

The risk of a structured product with participation is generally the same as that of the underlying. Unlike with a direct investment, however, you do not receive

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## RISKS IN SECURITIES TRADING

voting rights and you are not entitled to a dividend. You do, though, bear the credit risk of the product's issuer.

Many products with participation refer to several underlyings. You as investor receive the security with the worst performance on expiration (either physically or in the form of cash) if the market value of the underlying touches, rises above or falls below a predefined barrier during the term of the financial instrument. The financial instrument can trade some way below the issue price during its term even if the barrier is not touched, exceeded or undershot. Moreover, the level of participation is directly related to the level of the barrier. If you have a higher risk tolerance when selecting the barrier, you will enjoy a higher participation.

### What is the maximum possible loss?

**PLEASE NOTE:** When you invest in a structured product with participation, you could in the worst case lose the entire capital that you have invested.

## 4. Leverage products

### What are structured products with leverage?

Structured products with leverage enable you to participate disproportionately in the performance of the underlying. The leverage occurs because the same performance can be achieved as with the underlying, but with a lower investment of capital. This means you can benefit from short-term trends.

Structured products with leverage are suitable for short-term speculation but also for strategically hedging a portfolio.

### What special risks do you need to bear in mind?

Because of the leverage effect, you need to carefully and regularly monitor the underlying, since structured products with leverage can experience a larger rise in profits but also a bigger loss than the underlying.

### What is the maximum possible loss?

**PLEASE NOTE:** When you invest in a structured product with leverage, you could in the worst case lose the entire capital that you have invested.

## VII. Products used for financing or risk transfer

### What exactly are these products?

The financial instruments discussed under this heading combine traditional financial instruments for the purpose of financing or risk transfer. The risks associated with these derivative products are not necessarily the same as those of the financial instruments they contain. It is therefore extremely important to find out exactly what the risks are before acquiring a product of this kind. This information can be found in, for example, the product description concerned.

Such financial instruments may be listed for trading on an exchange, but do not have to be.

### What are credit and catastrophe derivatives?

There are some products that are mainly used to transfer risks. These include credit and catastrophe derivatives. They are financial instruments where the "underlying" is an event such as a credit event (default of a loan or bond) or a natural disaster. Derivatives of this type can be used by the bearer of a risk to transfer it to others. Credit derivatives come in the form of swaps, options or hybrid financial instruments.

**PLEASE NOTE:** Credit and catastrophe derivatives involve a liquidity risk. Often such instruments cannot be sold before the end of their term, because there is no market for them.

Credit bonds securitise the risks and transfer them to third parties as credit-linked notes, collateralised debt obligations and asset-backed securities. As a result, the buyer takes on the risk associated with a loan portfolio.

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- **Asset-backed securities (ABS)**

In ABSs, risks (such as a range of receivables) are grouped together and transferred to a special purpose vehicle (SPV). The SPV finances this transaction by issuing securities backed by a pool of assets or a portfolio. If the collateral is a mortgage, this kind of instrument is called a mortgage-backed security (MBS). The individual components of the portfolio would be unattractive or even unobtainable in this form for individual investors.

However, the composition of the portfolio makes it possible to combine together and sell a range of assets and risks. By grouping together different types of credit risk, different risk profiles can be created.

- **Credit-linked notes (CLN)**

CLNs are bonds whose redemption and interest payments depend on the performance of a specific underlying or benchmark portfolio (e.g. loan, bond).

Look closely at the creditworthiness of the borrower to which the CLN is linked, as the CLN can end up being valueless if a credit event occurs. There is an issuer risk, i.e. a credit risk of the issuing bank, just as with structured products. The secondary market for CLN is highly illiquid, and you should therefore assume that you will not be able to sell one before the end of its term.

- **Collateralised debt obligations (CDO)**

CDOs are bonds backed by a diversified debt portfolio (mostly loans, bonds or credit default swaps). They give you access to investments that are unattractive or even unattainable for individual investors. Since CDOs are often divided up into a number of tranches with differing credit risks, you can decide what credit risk you wish to take on. If a borrower in the debt portfolio experiences a credit event, the share-like tranches are affected first: they may be only partially redeemed, or not redeemed at all. If a number of borrowers default, this affects the remaining tranches in order of creditworthiness, until finally the tranche with the highest credit rating (comparable to that of first-class bonds) may only be

partially redeemed, or not redeemed at all.

The value of a CDO is based primarily on the probability of a credit event affecting the individual companies in the portfolio. This probability of default is determined using statistical methods and on the basis of historical data, and can cease to be meaningful in extreme market conditions.

Before you invest in a CDO, you should also look at the track record of the manager in charge of it: he or she will receive a performance-related bonus and will often have a holding in the CDO him / herself. If the portfolio is not run by a manager (which is termed a "static" portfolio), its composition remains unchanged throughout its term. In this case you should pay special attention to the composition of the portfolio.

CDOs typically have a term of several years. As there is generally no secondary market, you should assume that you will not be able to sell the CDO before the end of its term.

Even if a pool or portfolio is created, lack of diversification can lead to a concentration of risk.

**PLEASE NOTE:** Credit bonds are often issued by particular types of offshore companies, so-called Special Purpose Vehicles (SPV). In this event you should pay special attention to the issuer risk and the quality of government supervision of such SPVs.

## VIII. Alternative (non-traditional) investments

### What are alternative or non-traditional investments?

Alternative or non-traditional investments are investments that do not fall within the traditional asset classes, such as shares, bonds or money market products. They include a wide range of instruments and strategies. This section focuses on the classes that are most important in terms of risk information:

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- hedge funds (see page 29)
- private equity (see page 31)
- real estate (see page 32)
- precious metals and other commodities (see page 32)

This list is not exhaustive and this brochure cannot point out all the risks and aspects that need to be taken into account in connection with alternative or non-traditional investments.

**PLEASE NOTE:** In addition to the general risks (see pages 7 et seqq.), alternative investments are subject to high product-specific risks. Be sure to obtain comprehensive advice before investing in alternative or non-traditional investments, and examine the offering carefully.

You can invest in alternative and non-traditional investments either directly or indirectly.

### **What do you need to bear in mind when making direct investments in alternative or non-traditional investments?**

Instruments allowing for direct investment can make sense in terms of diversifying a portfolio (risk distribution) because their returns are less dependent on factors such as the performance of the markets and levels of interest rates than those of conventional investments. However, the minimum outlay required for direct investments is generally very high, and they are often not accessible to all investors.

### **What about indirect investments in alternative or non-traditional investments?**

To overcome these obstacles and avoid the risks of the large direct investments required, the financial sector has developed instruments for indirect investment. They include certificates, notes, investment funds, funds of funds, commodity futures and forward contracts. All these structures are based on one or more of the asset classes mentioned below. If you are interested in indirect investments, you need to bear in mind not just the risks of alternative investments as an asset class, but also the risks of the instrument concerned – the risks associated with structured products, for example. Please note that this section does not deal

with the risks of structured products, forward contracts and futures, as these were discussed in the preceding sections.

## 1. Hedge funds

### **What are hedge funds?**

Hedge funds are the best-known form of alternative or non-traditional investments. Despite what their name suggests, hedge funds do not necessarily have anything to do with hedging. Indeed, they take on sometimes very high levels of risk in order to obtain an above-average return.

Hedge funds include all forms of investment funds, investment companies and partnerships that use derivatives not just for hedging but also for investment, that are able to engage in short selling or take on significant leverage by borrowing. Other features typical of hedge funds include their freedom to choose their asset classes, markets (including emerging markets) and trading methods. Hedge funds normally require high minimum investments. They frequently offer only limited opportunities for subscription and redemption, with long notice periods. The portfolio managers of hedge funds receive performance-related bonuses and often hold a personal stake in the funds.

### **What should you particularly bear in mind about hedge funds?**

**PLEASE NOTE:** Pay special attention to the following:

- A hedge fund may be less transparent than a traditional investment fund, for example, as investors are not always informed about planned strategies and changes to them, or changes of portfolio manager. Hedge funds are also not subject to any disclosure requirements.
- Unlike traditional collective investments, hedge funds have limited liquidity (units may generally only be redeemed once a month, quarterly or annually). Normally, investors can only invest in a



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hedge fund at specific times. There are generally long notice periods for redemptions and "long lock-up periods" (periods during which investors are obliged to leave their capital in the fund).

- Delays may occur, and unfavourable prices may result, when settling buy and sell orders for hedge fund units. There is no guarantee that investors will be able to enforce their rights.

### What are funds of hedge funds or multi-manager hedge funds?

Investors invest in funds of hedge funds (FoHF) or multi-manager hedge funds in order to reduce risk. These funds invest their capital in a number of hedge funds and spread it across a range of hedge fund managers that cover different investment styles, markets and instruments. There are also structured products that you can use to invest in hedge funds or hedge fund indices.

### What strategies do hedge funds pursue?

The main hedge fund strategies seen on the market are as follows:

- Equity hedge ("long", "short")  
Equity hedge funds identify undervalued (buy or long position) and overvalued (short selling or short position) Equities in specific regions or market segments. The hedge fund manager attempts to make profits in the belief that sooner or later these positions can be closed out at a profit.
- Arbitrage strategies  
Arbitrage strategies identify price differences between identical or similar investments in different markets and try to exploit them. Such strategies include equity-market neutral, fixed-income arbitrage, convertible-bond arbitrage and mortgage-backed-securities arbitrage.
- Event-driven  
Managers that pursue this kind of strategy try to make a profit from events such as upcoming changes in a company (mergers, takeovers, restructurings, turnarounds, etc.). Examples of such strategies are

merger arbitrage, distressed securities and special situations.

- Global macro  
Hedge funds that pursue global macro strategies attempt to identify macro-economic developments such as changes in interest or exchange rates at an early stage and exploit them for profit. This category includes growth funds and emerging market funds.
- Managed futures  
This type of hedge fund deals in futures (standardised, exchange-listed contracts) on financial instruments, currencies and commodities.

### What risks do you take on when you invest in a hedge fund?

Generally speaking, hedge fund managers do not need to be licensed by an authority and are largely unregulated. In particular, hedge funds are not subject to the numerous investor protection regulations that apply to authorised collective investments. These include rules on liquidity, redemption of fund units at any time, avoiding conflicts of interest, fair prices for fund units, disclosure and limitations on borrowing.

Since these rules do not apply to hedge funds, they can use much more leverage than traditional authorised funds, and engage in complex investment transactions that are not permitted for traditional collective investments. A hedge fund is allowed to adopt aggressive strategies including the widespread use of short selling, leverage, swaps, arbitrage, derivatives and programme trading. Their investment strategies are often highly complex and very intransparent. You will often receive little or no information about changes of strategy that may lead to a significant increase in risk, or receive such information only at a late stage.

As part of their investment strategy, hedge funds can also use derivatives such as futures, options, speculation on difference, and equity swaps that may be listed for trading on an exchange but do not have to be. These instruments may be subject to significant price volatility, resulting in a high risk of loss for the fund. The low margins typically required to build up a

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position in such instruments mean that high levels of borrowing can be used. Depending on the instrument, a relatively small change in the price of the contract can therefore lead to a large profit or loss in comparison with the capital lodged as collateral and hence to further, unforeseeable losses that can exceed any margin cover.

**PLEASE NOTE:** Investment vehicles that are not listed on an exchange or regulated market also involve further risks as there is neither an exchange or regulated market nor a secondary market where units can be sold or open positions closed out. It may be impossible to unwind an existing position or determine the value or risk of a position. If a hedge fund sells uncovered options on securities, it may be exposing itself to an unlimited risk of loss.

### 2. Private equity

#### What is private equity?

Private equity is a form of risk capital financing for companies that either are listed on an exchange or regulated market or – occasionally – wish to delist. Investments are usually made at an early stage in a company's development, when its chances of success are uncertain and the risks are therefore high.

Where private equity flows into young companies ("start-ups") or small companies with growth potential that are at an early stage in their development, the term venture capital is also used. Private equity now also extends to risk capital made available to a company immediately before it goes public ("late-stage" financing, "mezzanine" financing). Normally the financing is constructed in such a way that the proceeds of the initial public offering are used to wholly or partially redeem the holdings of the shareholder entrepreneurs. If a change of ownership is financed, for example a delisting, the term "buyout" is customarily used.

The success of a private equity investment depends on the correct timing of the "exit" or sale and – especially with indirect investments via a fund, for example – on

the quality of the private equity manager. The exit can be effected by going public ("initial public offering" or IPO), a sale to another company ("trade sale") or to another private equity fund (secondary sale), or a management buyout. The choice of solution will depend largely on the market conditions prevailing at the time. How easy or difficult the exit phase is, and whether the proceeds meet expectations, will depend on factors such as the performance of the equity markets.

#### What are the risks of private equity investments?

Private equity investments are not regulated compared to equities listed for trading on an exchange. This means that investors may be exposed to more risks, for example due to lack of transparency (e.g. limited access to financial statements, lack of publication).

Private equity investments involve considerable risks and can lead to substantial losses. They are based on a long-term approach and are much less liquid than exchange-listed equities. Normally, private equity investments cannot be sold until some years after the original investment. You should be aware that your capital will be tied up, either completely or with access subject to restrictions, for a long time. No distributions are made prior to exit from investments. You do not normally have any entitlement to exit early. Companies that are potential candidates for private equity investments may have high levels of borrowing and therefore be more sensitive than established companies to negative market developments such as rising interest rates. There is also a greater danger of the company becoming insolvent and going bankrupt than with listed companies.

**PLEASE NOTE:** It is not unusual for further calls for capital to be made at short notice after the initial investment. If you fail to comply with such a demand, you may lose all the capital you have invested up to that time.

**PLEASE NOTE:** A change of management in a young company where the personality of the individuals occupying key functions is a particularly

important factor can have a highly detrimental effect on a private equity investment.

### **What do you need to bear in mind when making indirect investments?**

With indirect investments, there is no guarantee that the manager of a private equity fund will be able to make investments and generate profits that fulfil the expectations for this form of investment. The abilities of the private equity manager are therefore crucial to the success of an indirect investment.

## **3. Real estate**

### **How can you invest in real estate?**

Investments in real estate can be made directly or indirectly. Real estate comprises office buildings, retail and industrial premises, residential property and special real estate (such as hotels or hospitals). The variables that determine the value of a property are its location, construction, equipment fittings and the variety of ways in which it can be used.

### **What do you need to bear in mind when making direct investments?**

A direct investment involves actually buying property. This will usually require a high capital outlay, a long term investment horizon, in-depth knowledge of the sector, familiarity with the location and often personal involvement, as property needs to be professionally managed.

### **What about indirect investments?**

Indirect investments in real estate generally require a lower capital outlay than direct investments. Indirect investments are divided into those that are exchange-listed and those that are not. Examples of unlisted indirect investments include real estate funds, shares of real estate companies that are not listed for trading on an exchange, and certificates on real estate funds. Real estate funds can reduce risk by diversifying across geographical areas and real estate categories. The main category of exchange-listed indirect investments is "real estate investment trusts" (REITs).

### **What risks do you need to be aware of when investing in real estate?**

Real estate investments are based on physical assets – land and buildings – in which trading is not regulated.

Where real estate is concerned, it is therefore often difficult, or even impossible, to spread risks adequately or diversify investments sufficiently. With direct real estate investments especially, broad spreading of risks by region, real estate type, and use of the property is only possible with substantial investment volume.

Property markets are also frequently intransparent, and require precise knowledge of local circumstances. It is therefore vital to involve local experts, which hampers access to the market. Real estate often reacts to interest rate changes in a similar way to bonds: when interest rates are low, for instance, mortgages are cheap and it is easy to generate above-average profits. Conversely, high interest rates cause profits to contract. Fiscal incentives offered by the state to promote home ownership and attractive lending conditions can also lead to excessively high prices.

## **4. Precious metals and other commodities**

### **What are commodities?**

Commodities are physical goods that are produced via agriculture and mining, for example, and standardised for use as the underlying of a transaction. Derivatives on commodities such as energy sources, precious and other metals, and agricultural products are traded on futures markets.

Contractual agreements allow investors to buy or sell futures linked to the performance of a particular commodity. This means that they can buy a standardised amount of a commodity at a specific time in the future for a specific price.

The commonest way in which private individuals invest indirectly in commodities is via structured products. There are other alternatives, such as commodity swaps and options that are not listed for trading on an



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exchange. These are traded directly between the parties concerned and are tailor-made products. More information on how forwards and futures work can be found above in this brochure (see page 20).

**PLEASE NOTE:** With commodity futures, you may receive physical delivery of the commodity concerned on expiration, while structured products normally provide for cash payment. If you prefer cash settlement, you will have to close out the futures on time. Such products are therefore more risky than, for instance, shares or investment fund units.

### What are the risks of commodity investments?

The price of commodities is influenced by a number of factors. These include:

- the relationship between supply and demand
- climate and natural disasters
- state programmes and regulations, national and international events
- state intervention, embargoes and tariffs
- movements in interest and exchange rates
- trading in commodities and the corresponding contracts
- provisions relating to monetary policy, trading, fiscal and currency controls.

These variables can lead to additional investment risks. Commodities investments are more volatile than conventional investments, and yields on commodities can collapse at short notice. The volatility of commodity prices also affects the value, and hence the price, of a futures contract based on those commodities.

Conventional futures on oil, base and precious metals are normally easy to trade, regardless of their term.

**PLEASE NOTE:** When market activity is limited, a contract can become illiquid. Depending on how the yield curve moves, such illiquidity can lead to significant price changes. This is a typical feature of commodities.

## Section Three: Additional information

### I. Investments in emerging markets

#### What are emerging markets?

There is no standard definition of the term "emerging markets". In the broadest sense, the term includes all countries with markets that are not yet established, but with one or more of the following characteristics: lack of political stability, uncertain financial markets and economic development, financial market under development, or an economy that is still weak. Common criteria for defining what is an emerging market are per capita income, the level of development of the financial sector, and the proportion of the total economy that is made up by the service sector.

The creditworthiness (credit rating) of countries that fall within this definition can vary widely: from very high to very low, with – in the latter case – very high default risk.

Although they can be at very different stages in their economic development, most emerging markets have a political system that is very new (for instance they have only recently become democracies) or is currently changing. This means that the political system and its institutions may be less stable than in an advanced nation.

#### What factors should you be especially aware of when making investments in emerging markets?

There are risks linked to investments in emerging markets that are not encountered in their advanced counterparts. This is also the case when the issuer or provider of a product has its headquarters or primary focus of activity in an emerging nation.

**PLEASE NOTE:** Investing in products linked to emerging markets is therefore often speculative. Before investing in emerging markets, you should form an impression of them that allows you to assess the risks involved.

#### What are the individual risks involved?

When investing in emerging markets, the following risks should be taken into account, some of which have already been mentioned in general; special attention must be paid to the specific circumstances of the country concerned. The list is not exhaustive. Depending on the type of investment product, there may of course be additional risks involved as described elsewhere in this brochure.

- **Settlement risk**  
Certain emerging markets have very different clearing and settlement systems, if at all. These are often outmoded and prone to processing errors as well as considerable delays in settlement and delivery. Some countries do not have any such systems at all.
- **Issuer risk (credit risk)**  
Investments in debt securities (e.g. bonds, notes) issued by emerging market governments or companies tend to entail higher levels of risk than established market debt. This can be due to inferior creditworthiness, a high level of government debt, debt restructuring, a lack of market transparency or a lack of information. It is also much more difficult to assess credit risk due to inconsistent valuation standards and the absence of ratings.
- **Liquidity risk**  
Liquidity is dependent on supply and demand. The impact on the emerging markets of social, economic

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and political changes or natural disasters can involve a much more rapid and lasting change to this supply and demand equation than would be the case in the established markets. In an extreme case, illiquidity can be the result. This can make it impossible for an investor to sell his / her investments.

- **Market risk / price fluctuation risk**

Because there is little or no supervision of financial markets in emerging market nations, regulation, market transparency, liquidity and efficiency are often inadequate. Moreover, high volatility and large price differences are characteristic of these markets. Finally, the inadequacy or absence of regulatory measures gives rise to an increased danger of market manipulation or insider trading.

- **Country risk / transfer risk**

A government's political inexperience or the instability of the political system increases the risk of short-term, fundamental shifts in a nation's economy and politics. The consequences for you as an investor can include the confiscation of your assets with no compensation, the restriction of your rights of disposal over your assets, or government-imposed controls. State intervention in specific sectors of industry can result in a dramatic fall in the value of investments in those sectors.

Legislation to protect the rights of shareholders and creditors (e.g. duties of disclosure, insider trading ban, management responsibilities, minority shareholder protection) may often be inadequate or non-existent. The absence or inadequacy of financial market supervision can lead to your legal rights being difficult or impossible to enforce. Moreover, legal uncertainty may exist due to the inexperience of the emerging nation's judiciary.

Emerging market economies are more sensitive to changes in interest and inflation rates, which are in any case subject to greater swings than in the developed nations. The focus of such economies is often relatively narrow, allowing single events to have a magnified impact. In addition, emerging nations generally have a lower capital base. Finally,

their financial markets often lack an adequate structure and sufficient supervision.

- **Current risk and inflation risk / monetary value risk**

The currencies of emerging market countries are subject to greater unpredictable fluctuations in value than those of established markets. It is also extremely important to note that some countries limit the export of their currency or can impose short-term restrictions. Hedging can help limit losses resulting from currency swings, but they can never be entirely eliminated. Large fluctuations in the value of the currency and an insufficiently developed financial market can make it difficult for an emerging market nation's central bank to stick to its inflation targets. As a result, inflation may fluctuate more than in advanced countries.

## II. Guarantees

### What is a guarantee?

The term "guarantee" may have different meanings. On the one hand, it may mean the assurance of a third party different from the issuer, with which the third party ensures the settlement of the issuer's liabilities. Such a guarantee can limit the credit risk. The guarantor only is liable to the extent of the guarantee, however.

On the other hand, a guarantee may also be the assurance of the issuer to provide a certain performance irrespective of the development of specific indicators that would in principle determine the amount of the issuer's obligation. Such a guarantee can limit the liquidity risk.

## III. Securities lending

### What is securities lending?

The term "securities lending" means the lending of securities in exchange for payment of a fee. It is a legal transaction similar to a loan, in which the lender temporarily undertakes to transfer ownership in certain securities to the borrower, while the borrower under-

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## RISKS IN SECURITIES TRADING

takes to reimburse securities of the same type, amount, and quality and to transfer any earnings to the lender for the duration of the securities lending contract.

### **What are the advantages of securities lending?**

The advantage of securities lending is that the lender can generate an additional return on the securities thanks to the lending fee, without having to enter into greater risks. As a rule, the borrower (generally a custodian bank) receives collateral in the form of securities or cash.

### **What are the disadvantages of securities lending?**

The disadvantages of securities lending are that the lender no longer has membership rights (participation in the general meeting, voting rights) for effectively lent securities (shares) and, in the case of registered shares, re-entry in the share register is not guaranteed.

### **What are the risks involved in securities lending?**

The main risks are counterparty and price fluctuation risk. If the borrower is unable to return the borrowed securities at all or on time, the lender may be forced to sell collateral and buy the originally lent securities on the market. The lender may then suffer a loss.

Please note also that securities lending may have specific tax implications in the country in which the lender is resident, given that such transactions do not constitute investments but involve the borrowing and lending of securities.

## **IV. Performance of financial instruments under different market conditions**

### **What determines the performance of financial instruments?**

As a general rule, the performance of financial instruments is determined by the principle of supply and demand. If demand for a particular financial instrument increases on an organised market (e.g. a stock

exchange) or outside an organised market, the value of the financial instrument will increase. If demand decreases, the price of the financial instrument concerned, whether on an organised market or outside an organised market, will usually decrease as well.

Increases or reductions in demand may be caused by different market conditions. Positive company reports, good financial results or a company's good reputation in general may boost demand for its shares or other financial instruments because investors want to invest in the shares of companies that have performed well or in financial instruments offering the prospect of good returns. Less positive information released about companies may have precisely the opposite effect, potentially causing demand for the financial instruments to decrease and their value to decline.

However, the performance of a financial instrument is not just affected by the information on the issuer but also by other market factors, such as the political climate, the macroeconomic situation on various markets and general trends and market sentiment. If the interest paid on bonds increases, for example, demand for equities may decrease, and vice versa. The same impact can be perceived for certain regions or sectors, for example if interest rates only increase in certain countries. This may reduce demand for bonds or equities in other countries, so that capital gains will be realised in the country where rates are rising, triggering losses on bonds and equities in the other country or region. Even if rates are generally increasing within a given country or region, this may cause losses on existing bonds if the yields on such bonds are comparatively low.

A generally critical sentiment towards specific industries, technologies or regions may cause demand to contract, even though reports on particular companies may be viewed favourably. There are therefore a wide range of factors which, taken together, create the market conditions affecting the price of a financial instrument. For further information on factors that may impact the markets for various financial instruments, we recommend reading the relevant prospectus and product information.

## **V. Barriers to minimising misinvestments**

### **How can misinvestments be minimised, and what are the barriers preventing this?**

In general, investors look for opportunities to minimise misinvestments, which usually means selling investments that have been purchased previously. However, they often encounter barriers to minimising misinvestments, for example in situations where a particular financial instrument is illiquid. Further information on liquidity risk is set out on page 7 of this brochure.

Fixed maturities for financial instruments may pose a further obstacle. If the financial instruments cannot be redeemed or income distributed until the end of the specified term, there may be no liquid market in which to sell. If there is no market in which to sell such financial instruments, investors must wait until the maturity date before receiving redemption payments or distributions of income. During the term to maturity, investors may not be able to sell or generate income on the financial instrument, or may only be able to do so by incurring a loss.

If necessary, investors must take steps to exit their investment through a private sale, which will preclude them from redeeming the financial instrument from the issuer or realising any proceeds by selling it on a liquid market. Financial instruments may also become illiquid unexpectedly if demand for the instrument suddenly collapses.

In this type of scenario, or similar scenarios, there is a risk that investors will not recover the initial transaction costs for the financial instrument concerned through capital gains, payouts or distributions. Transaction costs are generally incurred on purchasing financial instruments. If transaction costs of 2 % were charged, for example, and the financial instrument yielded an annual net return of 2 %, it would take investors a year to recover the initial transaction costs paid. Given initial transaction costs of 4 % and assuming the same net return, a two-year time frame would be required before the initial transaction costs were recovered and the financial instrument could be sold.

In many cases, it is only possible to make accurate assessments in retrospect once detailed information on the relevant market trends becomes available. We therefore recommend reading the relevant product documents and, in particular, the sales prospectus and product information.

# Appendix 1:

## Overview of the characteristics and risks of selected financial instruments

Financial instrument	Characteristics	Characteristic risks
<b>Asset-backed security (ABS)</b>	In its basic form, provides for the sale of the receivables of a company or a credit institute to a vehicle specially formed for this purpose ("Special Purpose Vehicle"). The sole task of the special purpose vehicle is to buy the receivables and to refinance them by issuing securities backed by the receivables.	Like <b>"straight bond"</b>  Of special importance, however, are issuer risk / credit risk and liquidity risk.
<b>Bond ex warrant</b>	Like <b>"straight bond"</b>	Like <b>"straight bond"</b>
<b>Bond with warrant attached</b>	Represents a pecuniary claim against the issuer (borrower). Depending on the market situation, it may offer a higher return than other fixed-interest investment instruments. The warrant entitles the holder to participate directly in the success of the company by subscribing for shares.	Like <b>"convertible bond"</b>
<b>Call option</b>	Standardised buy option, traded on exchange (EUREX or other derivatives exchange). <u>For the buyer:</u> Like <b>"warrant"</b> <u>For the seller:</u> Possibility of gaining additional earnings or improving the return on an existing position.	<u>For the buyer:</u> Like <b>"warrant"</b> <u>For the seller:</u> Like <b>"warrant"</b> Additionally: Risk of having to sell the underlying instrument below its current market price.
<b>Certificate of deposit (CD)</b>	Represents a short-term pecuniary claim against a bank.	<ul style="list-style-type: none"> <li>• Issuer risk / credit risk</li> <li>• Monetary value risk / inflation risk</li> <li>• Country risk / transfer risk</li> <li>• Liquidity risk</li> <li>• Market risk / price fluctuation risk</li> <li>• Currency risk</li> <li>• Interest rate risk</li> </ul>



## Appendix 1

## RISKS IN SECURITIES TRADING

Financial instrument	Characteristics	Characteristic risks
<b>Collateralised debt obligation (CDO)</b>	Bond secured by diversified debt portfolio (usually loans, bonds, or credit default swaps).	Like " <b>straight bond</b> "  Of special importance, however, are issuer risk / credit risk and liquidity risk.
<b>Commercial paper</b>	Represents a short-term pecuniary claim in the form of a promissory note issued by an industrial or financial company.	Like " <b>Certificate of deposit (CD)</b> "
<b>Commodities</b>	Represent homogeneous mass goods; classic commodities are metals (gold, silver, copper, etc.), agricultural products (wheat, soy, etc.), and energy sources (crude oil, natural gas, etc.).	<ul style="list-style-type: none"> <li>• Market risk / price fluctuation risk</li> <li>• Liquidity risk</li> <li>• Country risk</li> <li>• Currency risk</li> </ul>
<b>Convertible bond</b>	Represents a pecuniary claim against the issuer (borrower). Depending on the market situation, it may offer a higher return than other fixed-interest investment instruments. The right to convert the bond into shares enables the holder to participate directly in the success of the company.	<ul style="list-style-type: none"> <li>• Issuer risk / credit risk</li> <li>• Monetary value risk / inflation risk</li> <li>• Country risk</li> <li>• Liquidity risk</li> <li>• Market risk / price fluctuation risk</li> <li>• Currency risk</li> <li>• Interest rate risk</li> </ul>
<b>Credit-linked note (CLN)</b>	Bond cancelled at expiration, if none of the agreed credit events occurred during the term.	Like " <b>straight bond</b> "  Of special importance, however, are issuer risk / credit risk and liquidity risk.
<b>Cross currency swap (CCS)</b>	Exchange of differently defined interests payable and of different currencies on a fixed nominal amount.	<ul style="list-style-type: none"> <li>• Issuer risk / credit risk</li> <li>• Country risk / transfer risk</li> <li>• Market risk / price fluctuation risk</li> <li>• Currency risk</li> <li>• Interest rate risk</li> </ul>
<b>Currency swap</b>	Combination of a spot exchange transaction with a forward exchange transaction.	<ul style="list-style-type: none"> <li>• Issuer risk / credit risk</li> <li>• Country risk / transfer risk</li> <li>• Market risk / price fluctuation risk</li> <li>• Currency risk</li> </ul>
<b>Debt register claim</b>	Represents a pecuniary claim against public or private institutions arising from a loan or credit entered in an official register.	Like " <b>medium-term bank note</b> "

**Appendix 1**

**RISKS IN SECURITIES TRADING**

<b>Financial instrument</b>	<b>Characteristics</b>	<b>Characteristic risks</b>
<b>Dividend-right certificate (non-voting, no par value)</b>	Like " <b>share</b> " (but with no membership rights)	Like " <b>share</b> "
<b>Eurobond</b>	Like " <b>straight bond</b> "	Like " <b>straight bond</b> "
<b>Exchange-traded fund (ETF)</b>	Listed investment fund units traded like shares.	Like " <b>unit of investment fund</b> "
<b>Forward</b>	Off-exchange foreign currency, money market, and precious metals trades, where delivery and payment are at a future date. All conditions (scope of contract, price, maturity, beginning of contract) are already negotiated at the time the contract is concluded.	<ul style="list-style-type: none"> <li>• Issuer risk / credit risk</li> <li>• High market risk / price fluctuation risk due to leverage effect</li> <li>• Liquidity risk</li> <li>• Country risk / transfer risk</li> <li>• Currency risk</li> <li>• Other risks depend on underlying asset</li> </ul>
<b>Forward exchange contract</b>	Purchase or sale of a traded foreign currency at a specific future date. The amount and price are agreed in advance.	<ul style="list-style-type: none"> <li>• Issuer risk / credit risk</li> <li>• Country risk / transfer risk</li> <li>• Market risk / price fluctuation risk</li> <li>• Currency risk</li> </ul>
<b>Future</b>	Standardised futures contract traded on-exchange (EUREX or other derivatives exchange), with high potential for price gains on the underlying instrument on account of the low initial margin (leverage effect). Possibility of hedging existing positions.	<ul style="list-style-type: none"> <li>• High market risk / price fluctuation risk due to leverage effect</li> <li>• Country risk / transfer risk</li> <li>• Currency risk</li> <li>• Other risks depend on underlying asset</li> </ul>
<b>Hedge fund</b>	Funds that are often domiciled offshore and, unlike traditional funds, primarily use alternative investment strategies and instruments free from legal restrictions. These include, for instance, borrowing, the use of derivatives to increase the level of investment (leverage), and the sale of assets not in the possession of the fund at the time of sale ("short sale").	<ul style="list-style-type: none"> <li>• Country risk / transfer risk</li> <li>• Liquidity risk</li> <li>• High market risk / price fluctuation risk due to leverage effect</li> <li>• Currency risk</li> <li>• Interest rate risk</li> </ul>
<b>Interest rate swap (IRS)</b>	Exchange of differently defined interests payable on a fixed nominal amount.	<ul style="list-style-type: none"> <li>• Issuer risk / credit risk</li> <li>• Market risk / price fluctuation risk</li> <li>• Interest rate risk</li> </ul>



## Appendix 1

## RISKS IN SECURITIES TRADING

Financial instrument	Characteristics	Characteristic risks
<b>Medium-term bank note</b>	Represents a medium-term pecuniary claim, e.g. against a Liechtenstein bank.	<ul style="list-style-type: none"> <li>• Issuer risk / credit risk</li> <li>• Inflation risk / monetary value risk</li> <li>• Market risk / price fluctuation risk</li> <li>• Liquidity risk</li> <li>• Interest rate risk</li> </ul>
<b>Money market instrument</b>	Financial instruments which, due to their maturity and their circle of issuers and investors, can be attributed to the money market. These include treasury notes, certificates of deposit and commercial papers, with the exception of payment instruments.	Like " <b>straight bond</b> "  Of particular importance, however, is liquidity risk.
<b>Mortgage bond</b>	Represents a pecuniary claim, e.g. against the Swiss central mortgage bond institutes.	Like " <b>medium-term bank note</b> "
<b>Notes</b>	Represents a medium-term pecuniary claim against the issuer (borrower)	Like " <b>straight bond</b> "
<b>Participation certificate (non-voting share)</b>	Like " <b>share</b> " (but with no membership rights)	Like " <b>share</b> "
<b>Private Equity</b>	Risk capital financing for companies that are normally not listed on an exchange or regulated market or want to withdraw from an exchange or regulated market, typically in the form of venture capital, capital for the non-exchange buyout of existing companies or parts of companies, or investments in companies in financial or operational difficulties ("special situations").	<ul style="list-style-type: none"> <li>• Country risk</li> <li>• Liquidity risk</li> <li>• High market risk / price fluctuation risk due to leverage</li> <li>• Currency risk</li> <li>• Interest rate risk</li> </ul>
<b>Put option</b>	Standardised sell option, traded on exchange (EUREX or other derivatives exchange). <u>For the buyer:</u> Like " <b>warrant</b> " Possibility of hedging existing positions. <u>For the seller:</u> Like " <b>call option</b> "	<u>For the buyer:</u> Like " <b>warrant</b> " <u>For the seller:</u> Like " <b>warrant</b> " Additionally: Risk of having to buy the underlying instrument above its current market value.
<b>Real estate</b>	Investments in real estate or in companies and investment instruments that operate in real estate or are invested in real estate.	<ul style="list-style-type: none"> <li>• Issuer risk / credit risk</li> <li>• Country risk / transfer risk</li> <li>• Liquidity risk</li> <li>• Market risk / price fluctuation risk</li> </ul>

## Appendix 1

## RISKS IN SECURITIES TRADING

Financial instrument	Characteristics	Characteristic risks
<b>Share</b> (domestic and foreign; bearer; registered, preference, ordinary, priority, voting)	As an equity paper, it represents a share in the company and therefore enables the holder to participate directly in the success of the company, e.g. through share price gains (capital and membership rights).	<ul style="list-style-type: none"> <li>• Issuer risk / credit risk</li> <li>• Country risk / transfer risk</li> <li>• Liquidity risk</li> <li>• Market risk / price fluctuation risk</li> <li>• Currency risk</li> </ul>
<b>Straight bond</b>	Represents a pecuniary claim against the issuer (borrower).	<ul style="list-style-type: none"> <li>• Issuer risk / credit risk</li> <li>• Inflation risk / monetary value risk</li> <li>• Liquidity risk</li> <li>• Market risk / price fluctuation risk</li> <li>• Currency risk (for foreign currency bonds)</li> <li>• Interest rate risk</li> </ul>
<b>Treasury bill</b>	Represents a short-term pecuniary claim against a state (especially USA, Canada, UK).	Like " <b>Certificate of deposit (CD)</b> "
<b>Unit of an investment fund</b>	Represents a participating share in an investment fund or an investment company and therefore enables the holder to participate directly in the success of the investment fund or the investment company.	Differs depending on the investment strategy (see fund prospectus); the most important are: <ul style="list-style-type: none"> <li>• Issuer risk / credit risk</li> <li>• Inflation risk / monetary value risk</li> <li>• Liquidity risk</li> <li>• Market risk / price fluctuation risk</li> <li>• Currency risk</li> </ul>
<b>Warrant</b>	It gives the holder a specific buying or selling right to other instruments within a stipulated period. On account of the leverage effect, price fluctuations are significantly higher than with a direct commitment.	<ul style="list-style-type: none"> <li>• Issuer risk / credit risk</li> <li>• High market risk / price fluctuation risk due to leverage</li> <li>• Country risk</li> <li>• Liquidity risk</li> <li>• Currency risk</li> <li>• Interest rate risk</li> </ul>

## Appendix 2

# Appendix 2: Financial instruments

According to Annex 2, Section C of the Banking Act, financial instruments are:

1. transferable securities of all classes traded on the capital market, such as
  - a) shares and other securities equivalent to shares or interests in companies, partnerships or other legal entities, including certificates (collateral notes) for such securities;
  - b) bonds or other securitised debt securities, including certificates (collateral notes) for such securities;
  - c) all other securities entitling to buy or sell securities or leading to a cash payment determined on the basis of transferable securities, currencies, interest rates or interest earnings or other indices and benchmarks;
2. money market instruments normally traded on the money market, such as treasury notes, certificates of deposit and commercial papers, with the exception of payment instruments;
3. units in collective investment undertakings: units in undertakings for collective investment in transferable securities, in investment undertakings and alternative investment funds;
4. options, futures, swaps, off-market forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices, or financial measures which may be settled physically or in cash;
5. options, futures, swaps, off-market forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);
6. options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled, provided that they are traded on a regulated market and/or a multilateral trading facility (MTF);
7. options, futures, swaps, forwards and any other derivative contracts relating to commodities that can be physically settled not otherwise mentioned in point 6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognized clearing houses or are subject to regular margin calls;
8. derivative instruments for the transfer of credit risk;
9. financial contracts for differences; or
10. options, futures, swaps, off-market forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances, or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other

derivative contracts relating to assets, rights, obligations, indices, and measures not otherwise mentioned in this Section C, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognized clearing houses, or are subject to regular margin calls.







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In the case of contradictions or discrepancies between this language version and the original German version the German language version shall prevail.

