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# CHARACTERISTICS AND RISKS OF CERTAIN FINANCIAL OPERATIONS



UNION BANCAIRE PRIVÉE



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## I. INTRODUCTION

Union Bancaire Privée (hereinafter referred to as “UBP”), whose registered office is in Geneva, is the principal bank of the UBP Group. It is authorised by the Swiss Financial Markets Supervisory Authority (FINMA) under the Swiss federal act on banks and savings banks. It has an international network of financial and banking branches and subsidiaries. The UBP Group ensures it complies with the laws of Switzerland and of all countries in which it operates, in particular as regards its duty to provide information on investment risk.

Without claiming to cover every possible situation, this brochure sets out to inform clients of UBP Group entities on the features of the main types of financial instruments and the risks of investing in them. It is meant to help you take appropriate investment decisions by enabling you to compare the risks involved in the different investment vehicles available.

Other documents have also been issued by the UBP Group (see below) which can help you assess your situation as regards applicable local laws and regulations.

The fiscal and legal implications of investing in securities (e.g. the obligation to declare) are not covered by this brochure. If necessary, expert advice should be sought.

Please read this brochure carefully and consult the UBP Group entity which handles your account if you have any further questions.

## II. SPECIFIC LOCAL RULES

### 2.1 Swiss entities

The Federal Stock Exchanges and Securities Trading Act (SESTA) governs the protection of clients that use the services of financial service providers. It sets out requirements to ensure such financial services are provided fairly, diligently and transparently and provisions regarding the creation and supplying of financial instruments. This law also requires securities dealers to provide their clients with clear and concise information on the general risks linked to the types of transaction used.

The obligation to provide information varies according to the client's experience and financial knowledge. It covers financial services and types of transaction involving potentially higher risks or having a complex risk profile, and in principle it does not cover the specific risk incurred in an individual transaction.

If the Bank offers a Key Information Document on a particular financial instrument, it will contain detailed information on the risks and costs involved.

UBP's website ([www.ubp.ch](http://www.ubp.ch)), under the “FinSA” section of its “Legal Aspects” heading, contains information on the FinSA, and its implications and effects for clients of the UBP Group's Swiss entities or clients whose banking relationship is booked in Switzerland, depending on whether they are classified as “Private Clients”, “Professional Clients” or “Institutional Clients”.

### 2.2 European entities

European Union Member States have been required to transpose into their own legislation the provisions of the European Directive on Markets in Financial Instruments (MiFID). UBP's website ([www.ubp.ch](http://www.ubp.ch)), under its “Legal Aspects” heading, contains information on the effects of the MiFID on the relations of clients with the European entities of the UBP Group, depending on whether they are classified as “Retail Clients”, “Professional Clients” or “Eligible Counterparties”.

Clients of the European entities of the UBP Group should consult the specific documentation provided, and contact their relationship manager if they have any further questions. This brochure is not directed at clients of UBP entities based in European Union countries.

### 2.3 Other entities

Clients of entities of the UBP Group that are neither in Switzerland nor in Europe should contact their relationship manager directly to discuss any questions concerning the effects of local regulations on their dealings with the Group. If necessary, additional information will be provided by the entity with which they are dealing. This brochure is valid by default as the minimum standard for non-Swiss and non-EU entities.

## III. DEFINITIONS

### 3.1 Financial intermediaries

The term “financial intermediary” refers to the UBP Group entity with which the client conducts business relations.

### 3.2 Financial instruments

In this document, the term “financial instrument” covers the following elements:

- Transferable or equity securities, i.e.:
  - Securities in the form of shares, including share-like securities allowing for participation or voting rights, such as participation or dividend rights certificates
  - Securities that, on conversion or execution of the rights embedded in them, allow for the acquisition of equity securities as soon as they are registered for conversion
- Debt instruments, i.e. securities that are not equity securities
- Money market instruments
- Units in collective investment undertakings
- Structured products such as capital-protected products, capped return products and certificates
- Derivatives
- Deposits with a redemption value or interest that depends on risks or prices, excluding those with interest linked to an interest rate index
- Bonds, i.e. shares of an overall loan subject to uniform conditions
- Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates and yields, and other derivative instruments, financial indices or financial measures which may be settled physically or in cash
- Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities which may 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 termination event)
- Options, futures, swaps and any other derivative contract relating to commodities which can be physically settled provided that they are traded on a regulated market and/or a MTF
- Options, futures, swaps, forwards and any other derivative contracts relating to commodities which can be physically settled and are not for commercial purposes, and which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls
- Derivative instruments for the transfer of credit risk
- Financial contracts for differences
- Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics, which 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, 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 recognised clearing houses or are subject to regular margin calls

### 3.3 Derivatives

Derivatives are financial instruments for which the price is derived from that of an underlying or basket of underlyings: assets (equities, bonds, units of mutual funds, precious metals and other commodities), benchmark rates (exchange rates, interest rates, indices), the occurrence of an event (credit incident, natural disaster), or derivatives (notes, certificates, warrants, futures, forwards, options, swaps). For instance, in the case of an equity option, the equity is the underlying from which the option derives its value. This brochure covers the different types of derivatives, including options, swaps, forwards and structured products.

### 3.4 Physical and book-entry securities

Physical securities are those that exist in physical form, namely as a piece of paper.

These days, most financial instruments no longer exist in physical form. They are known as book-entry securities – also referred to as uncertificated securities in the Swiss Federal Act on Intermediated Securities of 3 October 2008. Book-entry securities, including shares (see section 4.3.1), bonds (see section 4.3.2), collective investment schemes (see section 4.3.4), and structured products (see section 4.3.8), are so called because they are simply booked to a custody account rather than being held in physical form.

### 3.5 Issues and issuers

The word “issue” is used when a new security is offered for trading. Anyone who offers or intends to offer securities for trading is thus an issuer.

### 3.6 Financial service providers

A “financial service provider” within the meaning of Swiss law is anyone who provides financial services on a professional basis (i.e. as a permanent, independent and commercial activity) in Switzerland or for clients in Switzerland. Any economic activity carried out with the purpose of obtaining a regular income is deemed to be professional. Banks and other financial institutions also qualify as financial service providers.

### 3.7 Main financial services

The main financial services provided by UBP are the following:

- Wealth management
- Investment advice
- Order execution without advice (execution-only service)
- Loans for trading in financial instruments

#### a. Wealth management

Through wealth management mandates, clients entrust their assets to the Bank, with a view to having them managed according to parameters predefined in the Investment Profile for discretionary asset management mandates. The Bank must take into account the investment objectives established with clients and manage their assets in accordance with the agreement formed. Investment decisions are taken by the Bank.

When taking investment decisions under a portfolio management mandate, UBP's entities in Switzerland are not required to provide a Key Information Document (KID).

#### b. Investment advice

Investment advice consists of personal recommendations that relate to the trading of financial instruments.

It can be either portfolio-based (geared to the client's portfolio and defined investment strategy) or transaction-based (focused on individual financial instruments).

In Switzerland, only banks or other financial institutions with the requisite licence or persons entered in the FINMA's Register of Advisers may provide investment advice on a professional basis.

As part of an investment advisory agreement that takes into account the client's whole portfolio, which is the standard arrangement at UBP, the Bank recommends one or more financial instruments depending on parameters predefined with the client in the Investment Profile and Client Account Risk Profile (CARP), and the client takes the final investment decisions.

Investment advice relating to certain categories of financial instruments, e.g. collective investment schemes and structured products, obliges financial service providers to supply private clients with a key information document explaining how the instrument works as well as the risks and costs it involves.

### c. Order execution without advice (execution-only service)

This service is also known as “execution only”. The client places an investment order and UBP simply executes it, without making any recommendations or giving any advice. The client thus bears full responsibility for assessing investment instruments and the risks they entail.

However, for certain categories of financial instruments, e.g. collective investment schemes and structured products, UBP's Switzerland-based entities must supply the client with a Key Information Document (KID), if one is available, before carrying out transactions on an execution-only basis.

### d. Loans for trading in financial instruments

The Bank lends money to clients so that they can buy financial instruments (this is known as a “Lombard loan” – see Glossary). In return, the client pledges the financial instruments concerned to the Bank as security for the loan. This arrangement involves a higher level of risk because the client owes money to the Bank and must repay the loan at the end of its term. If the financial instruments fall in value as a result of market fluctuations, they may no longer provide sufficient security for the loan, and so the Bank may have to carry out margin calls (requests for the client to top up the value of the security by providing more assets). If the client fails to provide the additional security requested, the Bank may have to liquidate the portfolio resulting in a loss being realised for the client, while the client remains responsible for repaying the loan.

## 3.8 Direct and indirect investments

Direct investments involve investing in actual assets – such as shares, bonds, real estate, precious metals or commodities – directly. However, the minimum outlay required for direct investments is generally very high, and they are often not accessible to all investors.

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. Indirect investments involve investing in assets indirectly via an investment vehicle, for example a fund or structured product.

Direct and indirect investments can be used for different purposes. Funds for instance, focus on risk diversification, whereas structured products with participation or leverage (see sections 4.3.8 and Glossary) strive to maximise returns. Other investments offer the opportunity to invest in an otherwise inaccessible asset class, commodity certificates (so-called “baskets”) being a good example.

Whether an investment is direct or indirect has no bearing on its risks or returns. When deciding to invest indirectly, for example in alternative investments (see Glossary), it is important to consider not only the risk associated with the asset class, but also the risks attached to the financial instruments contained in the investment vehicle. This is also true for structured products.

## 3.9 Limited and unlimited risk

Financial instruments with limited risk entail the risk of making no profit and possibly losing all of the invested capital in a worst-case scenario.

With unlimited-risk instruments, the investors may even have to pay out more money on top of what they originally invested, in extreme cases even several times as much.



## IV. GENERAL RISKS OF INVESTING IN FINANCIAL INSTRUMENTS

This section explains the general risks involved in trading financial instruments.

### 4.1 General risks

The term “general risks” refers to the risks attached to widely-used financial instruments, such as equities, bonds and collective capital investments (e.g. units in mutual funds). These general risks can also affect the underlyings of derivatives.

General risks include:

#### 4.1.1 Counterparty risk or issuer risk

Most investments involve a risk that the issuer (see Glossary) will become insolvent (insolvency risk). This is called “issuer risk”. A financial instrument’s value depends not only on product-specific aspects – e.g. business results for equities or the performance of the underlying financial instrument for structured products – but also on the issuer’s creditworthiness. This can change at any time during the term of an investment. It is therefore important to know who issued the instrument in question and who is responsible for meeting the obligations. This is essential for correctly assessing the issuer’s creditworthiness and thus the issuer risk. With debt instruments (see Glossary) such as bonds, this risk is known as the credit risk because the borrower normally acts as the issuer. The debtor (issuer) can encounter financial difficulties and become insolvent.

#### 4.1.2 Country risk

The value of a financial instrument and thus the possibility of accessing it depend on various political, legal and economic factors relating to the country in which it is issued, held in custody or traded.

Country risks concern the political and economic stability of a given country.

Country risk arises if a country restricts securities trading, for instance by imposing economic sanctions or currency restrictions. Examples of political risks include the potential confiscation of assets and state intervention in certain industries. Economic risks typically include fluctuations in interest and inflation rates. Other country risks concern the quality of infrastructure (particularly as regards clearing houses and exchanges) and the legislative framework: market transparency, supervisory authorities, investor protection, insolvency regimes and taxation.

All of these can change over time, sometimes in unpredictable ways. In the past, for example, some states have imposed restrictions on trading in financial instruments via economic sanctions or controls on the exporting and free movement of capital. These can make it difficult or even impossible to retain control of or sell the financial instruments affected, even if they are held with a Swiss bank.

#### Countries with special risks: emerging markets

There is no standard definition of the term “emerging market”. Common criteria for defining emerging markets are income per capita, the level of development of the financial sector and the proportion of the total economy made up by the service sector. Emerging markets can be at very different stages of economic development, but one thing most of them have in common is that their political, legal and economic systems are either comparatively new (e.g. democracy) or not very firmly established. As a result, emerging markets’ financial systems and institutions tend to enjoy less stability and legal certainty than their counterparts in developed countries.

The creditworthiness of emerging countries can vary widely: from very high to very low, with – in the latter case – very high default risk.

Investments in emerging markets entail risks that are less pronounced or entirely absent in more developed countries, including settlement and liquidity risks (see the list of risks below). Higher risks are also associated with investments in financial instruments whose issuer (see section 3.5 and Glossary) or distributor has its head office or the focus of its activity in an emerging market.

**CAUTION: Investing in financial instruments linked to emerging markets is often speculative. Before investing in emerging markets, you should form an impression of them that allows you to assess the risks involved. If you wish to invest in emerging markets, do not disregard political, economic, credit, currency, inflation, country, liquidity or settlement risk. The list is not exhaustive. Depending on the type of financial instrument, there may be additional risks involved. Below is a description of the main risks.**

### **Political 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.

### **Economic risk**

Emerging market economies are more sensitive to changes in interest and inflation rates, which are in any case subject to greater swings than in more 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.

### **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 developed 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.

### **Settlement risk**

Settlement risk occurs when the client is required to pay the purchase price of a security in advance but does not actually receive the security until later. In this event, the risk is that the securities are delivered late or not at all, despite the fact that they have already been paid for. Settlement risk also arises where securities which have been sold are delivered before the sale proceeds are received. Settlement risks are especially high in emerging markets and for some offshore funds, private equity investments and derivatives (see Glossary).

### **Custody risk**

Financial instruments can be held either in Switzerland or abroad. Generally, they are held where they are most frequently traded, and are governed by the regulations that apply in the country concerned. In the case of the insolvency of a bank, Swiss law stipulates that financial instruments held on deposit are subject to a reservation of title in the client's favour and do not form part of the bankruptcy assets. However, insolvency proceedings can delay their transfer. If a third-party custodian becomes insolvent, the law in many foreign countries provides, like Swiss law, that the financial instruments deposited with that custodian by the bank are protected. In less developed markets, however, financial instruments deposited may be included in the bankruptcy assets.

### **Liquidity risk**

Liquidity risk is the risk that an investor will not always be able to sell an investment at an appropriate price. When specific financial instruments or derivatives are difficult or impossible to sell or can only be sold at a greatly reduced price, this is termed an illiquid market. The risk of illiquidity occurs in particular with unlisted and small-capitalisation companies, investments in emerging markets (see Glossary), investments with sales restrictions, some structured products and alternative investments (see Glossary). In addition, liquidity risks cannot be ruled out with bonds if they are merely held after issue (see Glossary) and hardly traded at all.

#### **4.1.3 Currency risk**

If a financial instrument is denominated in a currency other than the portfolio's reference currency (see Glossary), the risk of exchange rate fluctuations must be taken into account. Some financial service providers recommend using hedging instruments to minimise this risk or offer currency-hedged products. Currency risk can thus be mitigated, but – depending on the asset class and hedging technique in question – it cannot always be completely eliminated.

#### **4.1.4 Legal risk**

To evaluate the legal risk attached to an investment, its legal framework must be taken into account. This includes legal provisions on investor protection, for example investment guidelines and obligations regarding transparency, information and disclosure as well as bans on insider trading and duties of management. Attention must also be paid to the mechanisms and institutions that enforce the law, such as supervisory authorities, courts and ombudsmen.

The legal framework can affect the value of an investment (e.g. in cases of fraud) and limit the scope for investors to assert their rights. This can be important if an issuer (see Glossary) fails to meet its obligations.

#### 4.1.5 Economic risk

Changes in a country's economic activity tend to have an impact on the prices of financial instruments. This is referred to as economic risk.

#### 4.1.6 Interest rate risk

Bond investors run interest rate risks, especially during periods where rates are rising. In such cases the fall in bond yields generally causes losses if the bond is sold before maturity. This is due to the fact that new bonds are issued with higher rates, which makes existing ones less attractive.

#### 4.1.7 Inflation risk

Inflation risk is the risk that investors will suffer financial losses as the value of money declines. It is most pronounced for long-term investments in foreign currencies. The central banks of countries with less developed financial markets and low reserves of hard currency are sometimes unable to meet their inflation targets. As a result, inflation and exchange rates in such countries can fluctuate more severely than those in more developed countries.

#### 4.1.8 Soft factor risks

Prices of financial instruments do not just depend on "hard" facts like a company's business performance and forecasts, they are also influenced by subjective "soft" factors such as expectations, fears and rumours. There is thus always a risk that the price of a financial instrument might fall in the short term due to soft factors, even though its value objectively remains intact.

#### 4.1.9 Volatility risk

The prices of financial instruments go up and down over time. Financial experts use the term "volatility" to describe the range of these movements over a specific period. Volatility is a measure of market risk. The higher a financial instrument's volatility, the more risky an investment it is, as its value could fall sharply.

#### 4.1.10 Concentration risk

Concentration risks are caused by the way an investment portfolio is constructed. They arise when a single financial instrument, a small number of instruments or a single asset class makes up a large share of the portfolio. Portfolios with concentration risks can suffer greater losses than more diversified portfolios in a market downturn. Diversified portfolios spread their investments among different financial instruments and asset classes in order to reduce the overall risk of price fluctuations. When buying and selling financial instruments, it is important to take account of portfolio structure and in particular to ensure sufficient diversification.

Concentration risks at issuer, country, sector and financial instrument level must be taken into consideration. For example, an investor is exposed to issuer concentration risk when holding bonds, shares or any other instrument in a given company.

As part of an asset management mandate, the Bank seeks to ensure that investments are diversified by limiting a portfolio's exposure to financial assets. The Bank has defined maximum exposure limits for each type of asset depending on the client's investment profile. Unless the client instructs otherwise, the concentration limit is between zero for the most conservative profile and 30% for the most aggressive profile. In general, the concentration threshold changes according to the risk level defined in the investment profile.

Under Advisory mandates, the Bank recommends that clients maintain diversification in their assets. For that purpose, the Bank has established indicative maximum exposure limits of between 2% and 30%, based on the Client Account Risk Profile (CARP) and the financial asset risk profile (PRC), distinguishing between asset types according to whether they are individual securities (shares, bonds, structured products) or investment funds. Because investment funds are intrinsically diversified, limits for them are higher. It should be noted that the Bank does not take into account exposure to the underlying positions of funds alongside individual positions when calculating a portfolio's overall concentration.

Under Advisory mandates, clients remain free to take their own investment decisions and may, at their discretion, establish exposures greater than the Bank's stated limits. In that case, the Bank reserves the right to draw a client's attention to the risks that may result from a lack of portfolio diversification and warn the client about the resulting concentration risks. Clients remain in charge of their own decisions and may opt, for their own reasons, to have a portfolio featuring little diversification or one that is focused on one issuer, sector or type of financial instruments. However, clients assume sole responsibility for the consequences of this, which may include losing all of their investment.

Execution-only clients decide their investments and level of diversification by themselves. The Bank reserves the right to draw their attention to the risks that may result from a lack of diversification in their portfolios. However, clients remain in charge of their own decisions and may opt, for their own reasons, to have a portfolio featuring little diversification or one that is focused on a certain sector, certain financial instruments or certain issuers. They assume sole responsibility for the consequences of this, which may include losing all of their investment.

As regards issuer risk, the Bank has established concentration limits of up to 40% for its asset management and advisory mandates, beyond which it warns clients about concentration risk and the risk of losses that may result. Issuer risk means the risk that the issuer of a security will see a change in its financial position that may affect its ability or desire, actual or perceived, to make payments of interest or principal in a timely manner.

For clients invested in broadly diversified investment funds such as multi-asset funds or strategy funds, it should be pointed out that diversification in terms of financial instruments takes place at the level of the fund's underlying assets.

#### **4.1.11 Structuring risk**

Investments can be either direct or indirect (see below). Indirect investments are made through an investment vehicle, which may be a collective investment scheme (such as a fund), a structured product or an option. The way this vehicle is structured can affect the investment's risk profile and might even create new risks.

#### **4.1.12 Risks involved in credit-financed investments**

Special risks apply to an investment portfolio that is partly or wholly financed by borrowing, usually via a Lombard loan secured against the investments in the portfolio. Special risks apply to an investment portfolio that is partly or wholly financed by borrowing, usually via a Lombard loan secured against the investments in the portfolio.

##### **Leverage effect**

Investors need to be aware that using borrowed capital alters the risk / return profile of their portfolio. In some cases, it can increase the expected return on the capital they have invested, but this higher return comes with a higher investment risk due to the terms of the loan – interest costs and capital. These fixed borrowing costs are set against uncertainty regarding the value of the investment and its return. Investments made with borrowed capital are said to have a leverage effect, meaning that both potential returns and the risk of loss are higher. In addition to the risk that all of the invested capital may be lost, additional conditions to repay the loan may mean that the investor loses even more than was originally invested.

##### **Margin requirements and liquidity squeezes**

If the value of an investment falls below a certain level, the lender may require additional collateral to secure the loan. This is known as a margin call. In such cases, the investor may be asked to repay some or all of the loan. If the investor does not provide the additional collateral or make the repayment, the lender may liquidate some or all of the assets pledged as collateral for the loan at an inopportune moment, giving rise to an additional liquidity risk.

##### **Currency risk**

Loans are often taken out in foreign currencies to take advantage of lower interest rates, in which case the currency risk (see Section 4.1.3) must be taken into account as well.

#### **4.1.13 Sustainability risk**

Sustainability risks are defined as ESG (environmental, social and governance) events or situations that, if they were to occur, could have a material negative impact, actual or potential, on the value of an investment.

As part of its investment advice and portfolio management services, UBP takes into account and assesses all the main financial risks, including sustainability risks.

ESG risks and opportunities are explicitly included in UBP's traditional financial analysis and investment decisions, based on a systematic process and appropriate research sources.

ESG preferences are a client's preferences for investments that are sustainable from the environmental, social and governance point of view.

For additional information on the Bank's approach to sustainability risks and its responsible investment methodology, please see the "Sustainability Risk Framework" document available on the [www.ubp.com](http://www.ubp.com) website. "Sustainability risk framework"

## 4.2 Risks involved in buying, selling and custody – particularly abroad

### 4.2.1 Custody chain risk

In addition to the investor's bank, other parties (financial intermediaries, see Glossary) are usually involved in the buying, selling and custody of financial instruments and other assets. The Bank will often call on the services of a broker (see Glossary) for buying and selling, and custody is regularly handled by a number of parties making up what is known as the custody chain. Within this chain, the Bank normally entrusts financial instruments to a local third-party custodian, which in turn holds them with a central custodian, either directly or via additional third-party custodians. Financial instruments are in principle held in custody in the issuer's (see Glossary) country of domicile or in the country where they are most commonly traded on an exchange, although this does not have to be the case.

Graph 1 – Simplified illustration of a custody chain



Source: Swiss Bankers Association (SBA)

Third parties are often involved in derivatives transactions as well. Exchange-traded derivatives are either traded directly on an exchange or via brokers (see Glossary). Both exchange-traded and over-the-counter (OTC) derivatives must be reported to a trade repository (see Glossary).

The buying, selling and custody of financial instruments are subject to the local rules and market practices applicable to the external securities dealer or the market infrastructure, which has an effect on investors' rights.

Financial instruments held in custody abroad are subject to the applicable foreign laws, which may not offer the same protection as the law governing the banking relationship. Investors' rights – including voting rights and rights pertaining to the liquidation of a third-party custodian or central custodian – may therefore be affected or restricted.

### 4.2.2 Collective custody risk

The Bank generally entrusts financial instruments to a third-party custodian in its own name. With collective custody, however, several investors' financial instruments are held collectively by the third-party custodian, i.e. they are not held separately for each individual investor. The Bank is liable for its own actions, as well as for any loss or damage caused by the third-party custodians it uses, under the applicable legal provisions and any contractual agreements.

### 4.2.3 Third-party custodian's insolvency risk

If the Bank becomes insolvent, Swiss law requires in principle that any assets it holds in custody are kept separate (segregated, see Glossary) from the bankruptcy assets for the benefit of its custody account clients. However, investors should bear in mind that insolvency proceedings can delay the transfer of financial instruments to investors or other parties, usually financial intermediaries (see Glossary). If a third-party custodian becomes insolvent, some countries' laws require that the financial instruments it holds in custody for the Bank are kept separate from the bankruptcy assets. In some cases, however, financial instruments held in custody may also be included in the bankruptcy assets.

Investors with assets held in custody abroad are therefore generally exposed to a country risk, which also concerns the financial intermediary and financial market in question.

### 4.2.4 Disclosure obligation risk

A wide range of information may have to be disclosed when transactions in foreign financial instruments or Swiss financial instruments with a connection to foreign countries are executed and settled. This is the case, for example, with investment funds that have asset classes in foreign currencies as well as with trading locations and custody in foreign countries. Information may have to be disclosed to the financial institutions involved, financial market infrastructure providers and other third parties as well as authorities and issuers (see Glossary) of financial instruments. Such disclosure obligations are intended to combat money laundering, terrorist financing, market abuse and insider trading, to apply sanctions, to ensure good corporate governance or generally to comply with local rules. The Bank is often unable to execute transactions at all or to hold financial instruments in custody correctly without forwarding the required information. Disclosure may be required before or after a transaction or in connection with custody.

The financial institutions and financial market infrastructure providers to which information must be disclosed are primarily securities dealers, fund management companies, clearing houses, custodians and trade repositories. In some cases, these may forward information disclosed to them to Swiss and/or foreign authorities or other third parties. The same applies to the processing of cross-border payment transactions such as transferring the price of financial instruments bought or sold.

### More details on disclosure

Information to be disclosed may include the following: name, date of birth, copy of passport, nationality and domicile, details of beneficial ownership, client or recipient, instructions and trade details, transaction amount, current or prior holding of financial instruments, details of the economic background of specific transactions and information on the origin of the money used, the duration of the banking relationship, relationships with other involved parties, any representation relationships and any other required documents and information. Where companies are involved, information on their business activity, business purpose, ownership structure, beneficial owners, corporate structure and number of employees may be required, as may any other business-relevant information and documents.

The Bank is expressly authorised to transmit non-public information to certain foreign entities by Article 42c of the Financial Market Supervision Act (FINMASA). The Swiss Financial Market Supervisory Authority FINMA has published a circular on this topic as part of its supervisory practice (Circular 2017/6 "Direct transmission"). For this purpose, the Bank obtains its clients' consent to bypass certain confidentiality requirements, for example under banking secrecy or the Federal Act on Data Protection. This is provided in the General Conditions.

Information transmitted abroad and cross-border transactions are no longer protected (e.g. in terms of banking secrecy or data protection). Instead, they are subject to the provisions applicable in the foreign jurisdiction concerned, which may not offer the same level of protection. Foreign laws and official orders may require information to be forwarded to authorities or other third parties.

It must also be borne in mind that foreign laws can change quickly and that the conditions applicable to the trading and custody of foreign financial instruments – the obligation to disclose the investor's identity, for example – may change during the investment period. Investors are responsible for informing themselves of the tax and legal implications of the financial instruments in which they wish to invest, regardless of which financial services they use (i.e. investment advice, portfolio management or execution-only services).

#### 4.2.5 Tax treatment risk

As a rule, income from financial instruments and assets is taxed at different rates. For example, the tax rate on a financial instrument may depend on whether its income is recorded as interest or capital gains. Taxes and duties may also apply regardless of cash flows.

Foreign investments entail a risk of double taxation for countries that have not signed a double taxation treaty with the investor's country of domicile.

Particularly in the case of new and innovative forms of investment, the tax treatment can change during the investment period, for instance if the applicable legislation and case law are incomplete or in the process of changing when the investment is made.

Finally, it is conceivable that changes in tax law may affect the capital market as a whole. Even if the taxes actually payable remain the same, such changes may influence the prices of financial instruments.

**CAUTION: Investors are advised to consult a tax expert in order to assess the tax implications of investments, including those accompanied by information documents claiming that they offer tax advantages or even exemption from tax. Investors are advised to consult a tax expert in order to assess the tax implications of investments, including those accompanied by information documents claiming that they offer tax advantages or even exemption from tax.**

## 4.3 Financial instruments and their specific risks

### 4.3.1 Equity securities (shares, participation certificates and dividend rights certificates)

#### What they are

Equity securities include shares, participation certificates and dividend rights certificates. They embody a share in the ownership of a company and confer certain rights on the holder in relation to that company, such as voting and profit-sharing rights, and in some cases also pre-emption rights (preferential rights to buy any newly issued securities). Equity securities are not normally redeemable, but they are tradable and transferable on the secondary market.

#### Risks associated with equity securities

Equity securities are subject to a volatility risk that depends on a variety of factors, including the company's financial health, the general economic situation and interest rate levels. They do not pay interest. Instead, they typically pay out a share of profit, for example in the form of a dividend set by the company, usually in line with its business performance. Sometimes, however, no dividend is paid.

Equity securities are also subject to an issuer risk (see Glossary) in that a total loss is possible if the issuer goes bankrupt, in which case holders of equity securities are only taken into consideration once the company has settled all other claims against it.

### 4.3.2 Bonds

#### What they are

From the issuer's perspective, bonds are a form of fixed-term borrowing. The issuer (borrower) normally pays a fixed rate of interest at regular intervals. Most bonds are redeemed at the end of their term, and some can be redeemed early.

In addition to conventional bonds, there are special forms that, alongside their debt function, also have equity-like features from the issuing company's point of view. These include convertible, warrant and hybrid bonds (see further down in this section).

#### Risks associated with bonds

The price of a bond can fall during its term, in particular due to a lack of demand, rising interest rates or a decline in the issuer's creditworthiness.

Bonds are subject to market, issuer, liquidity, interest rate and currency risks. Holders of a bond can lose some or all of their investment if the issuer goes bankrupt as bonds are not classed as privileged claims – in fact, they are allocated to the third bankruptcy class (see Glossary).

## Detailed characteristics and risks of certain bonds and loans

### Convertible and warrant bonds

A convertible bond is a fixed-income security that normally bears interest at an agreed nominal rate with no adjustment for inflation. - It gives the holder the right to convert it within a predefined period and at a predefined ratio into an equity instrument from the same issuer, e.g. a share. If this conversion right is not exercised, the bond falls due for repayment at the end of its term. Convertible bonds are sometimes used as a means of exchanging shares between the shareholders of two companies that are merging, in which case they are known as exchangeable bonds. Instead of a conversion right, warrant bonds comprise an option, subject to certain conditions, to buy equity instruments in addition to the bond. Convertible bonds that must be converted into equity instruments at a specific time or under specific conditions are called mandatory convertible bonds. Mandatory convertible bonds issued by a bank are called contingent convertible bonds (CoCos).

**CAUTION:** When buying convertible bonds, investors should always consider whether conversion is mandatory and, if so, what conditions are attached. The right to convert a bond or exercise an option may also be restricted.

## Hybrid bonds

Hybrid bonds are debt instruments with certain equity-like elements, such as no fixed term, the possibility of postponing or cancelling periodic interest payments or – like equity securities – lower priority if the issuer is liquidated. Banks and insurers tend to qualify hybrid bonds as regulatory capital, while rating agencies can sometimes attribute them to the issuer's equity, depending on their structure. This makes them attractive for industrial companies as well.

**CAUTION:** The overview below is limited to the characteristic features and risks of the most commonly issued types of hybrid bond. Investors are advised to consult the term sheet and/or, in the case of Switzerland, the Key Information Document, relating to the financial instruments concerned before making a decision.

## Examples of hybrid bonds

### Issuers: banks

#### - Additional Tier 1 bonds

Additional Tier 1 bonds are subordinated (lower-ranked) bonds with no fixed term that are issued by banks to bolster their core capital ratio. They can be repaid by the issuer at face value on the same date each year. Their interest rate is fixed until the first possible repayment date and then usually adjusted every five years. Under certain circumstances, the interest (coupon) payment (e.g. quarterly or annually) must be suspended. Unpaid coupons are not carried forward. The value of the bonds may be partially or totally written off, or the bonds may be converted into equity instruments, when certain conditions are met: the issuer's Common Equity Tier 1 (CET1) ratio falls below a predefined threshold, e.g. 5.125% or 7%; the supervisory authority determines that the issuer is at risk of insolvency; or the issuer reaches the point of non-viability (PONV) and receives a commitment for emergency state support.

Since their mandatory conversion is contingent on a particular condition, Additional Tier 1 bonds are also known as contingent convertibles or CoCos (see section 3.4.1).

#### - Tier 2 bonds

Tier 2 bonds are subordinated bonds with a limited term that are issued by banks to bolster their overall capital ratio. Some Tier 2 bonds can be called by the issuer five years before the end of their term. In contrast to Additional Tier 1 bonds, interest payments cannot be suspended. If the supervisory authority determines that the issuer is at risk of insolvency, or if the issuer reaches the point of non-viability (PONV) and receives a commitment for emergency state support, the entire value of the bonds is written off (resulting in a total loss), or the bonds are converted into equity instruments.

#### - Contingent convertible bonds (CoCos)

CoCos are complex financial instruments, hybrid products with a combination of debt and equity-like features which can be automatically devalued or converted into ordinary shares depending on the structure of the product in order to absorb losses, should the issuer's financial position worsen beyond a predefined level, usually linked to a capital ratio. Within the issuer's capital structure, CoCos are treated as subordinated debt. They can be issued as Tier 2 bonds with a predefined maturity, in which case failure to pay the coupons is considered a default, or as Tier 1 bonds without a fixed maturity (like perpetual bonds), with coupon payments that can be postponed or cancelled at the issuer's discretion, like shareholders' dividends.

The client must be aware that CoCos are complex financial instruments, which are not appropriate for all investors. As they carry increased risk, the investor can lose a substantial amount or even all of the capital invested. Investors should seek advice from specialist CoCo professionals before investing. For some investment products such as CoCos, the Bank may be obliged by law, regulations or current practice to disclose information about the client's and/or beneficial owner's identity or personal situation in order to be able to execute the investment instructions or to maintain the investment on the client's account (for more information, see the relevant clauses in the General Conditions relating to the lifting of banking secrecy, data protection, and confidentiality provisions).

#### - Bail-in bonds / gone-concern capital

Bail-in bonds are issued as loss-bearing debt instruments in the event of insolvency measures. They are intended to ensure that a systemically important bank that has collapsed can make an orderly exit from the market and that systemically important services can be maintained. When a failed bank is restructured or wound up, bail-in bonds can be converted to equity or their nominal value reduced. In order to make them clearly distinct from conventional bonds, which have "preferred senior" or "senior unsecured" rank, bail-in bonds must be given a lower rank either structurally – by being issued (see Glossary) by a non-operating group holding company – or contractually. A new rank, "non-preferred senior", has therefore been created for them.



#### **Issuers: insurers**

Insurers also issue hybrid bonds to improve their regulatory capital ratios and exert a positive influence on rating agencies' assessments. As a rule, these bonds have a lower rank and a very long or unlimited term with an option for the issuer to repay them. Bonds that are not repaid have their interest rate reset at predetermined times. Coupon payments may be suspended and do not always have to be carried forward.

Hybrid bonds issued by insurers do not normally have loss-absorbing features – write-off or conversion to equity – prior to bankruptcy. However, there are exceptions from both Swiss and European issuers, so it is important to consult the product documentation before making a decision.

#### **Issuers: industrial companies**

Industrial companies issue hybrid bonds to strengthen their capital ratios and / or improve their ratings. As a rule, the bonds have a lower rank, an unlimited term and an option for the issuer to repay them. Bonds that are not repaid have their interest rate reset at predetermined times, usually with a margin relative to the original credit spread. Coupon payments may be suspended. In addition to the usual repayment arrangements, industrial companies can normally repay their hybrid bonds at any time at face value if certain factors (such as their financial reporting, rating or tax burden) undergo negative changes.

### **4.3.3 Money market products**

#### **What they are**

Money market products are debt instruments (see Glossary) issued as certificated or uncertificated securities (see Glossary) for short-term financing purposes. They have terms of up to one year. The purchase or sale price is the nominal or face value minus the total interest accruing over the term.

#### **Risks associated with money market products**

The value of a money market product can fall during its term. Since the issuer is often a government, the issuer risk is usually lower than for other fixed-income investments (see Glossary). However, there may be currency risks.

### **4.3.4 Collective investment schemes**

#### **What they are**

Collective investment schemes (also called "investment funds") are pools of assets supplied by investors to be jointly invested on their behalf. They make broadly diversified investments possible with a small amount of invested capital.

In Switzerland, collective investment schemes come in many different forms, the main one being contractual investment funds. They are strictly regulated: they are subject to approval and supervision by FINMA. Investors can choose from a wide range of foreign funds in addition to Swiss-domiciled ones.

As a general rule, collective investment schemes may adopt various strategies: money market, equities, bonds, asset allocation, real estate, commodities or alternative investments. The legal documents constituting a fund – the fund regulations, articles of association or fund contract – describe the investments it can make.

#### **Risks associated with collective investment schemes**

Funds are subject to the same market, volatility, country, currency, liquidity and issuer risks (see Glossary) as the investments they make. The extent of specific risks depends on their investment restrictions, risk diversification and use of investment techniques and derivatives.

The legal documents constituting a fund, its prospectus and (where applicable) for Switzerland, the Key Information Document (KID), describe its risk profile in detail.

## Detailed characteristics and risks of certain collective investment schemes

### Swiss collective investment schemes

Swiss collective investment schemes are governed by the Collective Investment Schemes Act (CISA), which recognises the following categories of collective investment scheme:

#### Contractual and company-law collective investment schemes

The main form of collective investment scheme in Switzerland is the contractual investment fund. Other forms are investment companies with variable capital (SICAVs), investment companies with fixed capital (SICAFs) and limited partnerships for collective investment.

With a contractual investment fund, the relationships between the investors, the fund management company and the custodian bank are set out in a fund contract. The fund management company manages the fund on behalf of the investors. It makes the investment decisions, keeps the accounts and performs all administrative tasks. The custodian bank holds the fund's assets in custody. It takes care of payments and is responsible for issuing and redeeming fund units. Contractual investment funds are open-ended funds, i.e. investors have the right to terminate the contractual relationship at any time by redeeming their fund units at the net asset value (NAV). New investors can also buy into the fund.

Fund management companies, SICAVs, SICAFs and limited partnerships are comprehensively regulated, require authorisation from FINMA and are supervised by FINMA. The assets of a contractual collective investment scheme under Swiss law are segregated (see Glossary) in favour of investors if the fund management company goes bankrupt. Such segregation is not required for SICAVs, SICAFs and limited partnerships as they are legally separate companies.

#### Open-ended collective investment schemes

Contractual investment funds and SICAVs are open-ended collective investment schemes. This means that investors are in principle entitled to redeem their units at any time, and new investors can invest into them at any time. Depending on their investment policy, however, there may be certain restrictions on the right to redeem units at any time.

#### Closed-ended collective investment schemes

SICAFs and limited partnerships for collective investment are closed-ended collective investment schemes. This means that investors have no fundamental legal right to redeem their units.

#### Securities funds and other funds for traditional and non-traditional investments

Open-ended collective investment schemes under Swiss law are divided into the following categories according to their investment guidelines: securities funds, other funds for traditional investments, other funds for alternative investments (see Glossary) and real estate funds.

Securities funds invest in securities or rights issued on a large scale and traded on an exchange or another regulated market that is open to the public. They are intended for investments in liquid financial instruments and can only invest in other financial instruments to a limited extent.

Other funds for traditional investments and for alternative investments are subject to less strict investment rules than securities funds. They also have more scope than securities funds as regards their use of investment techniques and derivatives.

### Foreign collective investment schemes

The legal structure and investment rules of foreign investment funds are determined by the laws that apply in their respective countries. Funds that comply with the EU Directive on Undertakings for Collective Investment in Transferable Securities (UCITS) are especially common. The Directive sets out requirements in terms of organisation, types of instrument used and liquidity that funds must meet in order to be sold to a broad spectrum of investors.

### Investment strategies of collective investment schemes

The investment opportunities open to collective investment schemes vary according to their legal form and category. The investment strategy set out in a collective investment scheme's legal documentation (fund regulations or articles of association, depending on the legal form) defines the investments it can make. Collective investment schemes' strategies are geared first and foremost to risk diversification. Below are some examples of possible investment strategies.

## Examples of investment strategies

### Money market funds

Money market funds invest in short-term, fixed-income instruments and are suitable for short-term investment purposes.

### Equity funds

Equity funds invest mainly in shares. They are normally categorised by geographical focus (country-specific, regional or global), sector or theme (e.g. banks, pharmaceuticals, technology) or company size (small, medium and large caps). Equity funds have high potential for returns over the long term but also a high volatility risk. They are therefore suited to investors with a long-term focus who wish to profit from the economic growth of one or more countries or sectors.

### Bond funds

Bond funds invest mainly in bonds with fixed or variable coupons, convertible bonds and warrant bonds. They are categorised primarily by currency, credit rating and length of term. They are suited to investors with a medium- to long-term focus seeking more regular income from coupon payments.

### Asset allocation funds

Asset allocation funds invest in a range of different asset classes, e.g. shares, bonds and real estate. Also known as portfolio, mixed or strategy funds, they pursue specific strategies. They offer a standardised form of asset management tailored to investors' individual objectives and risk tolerance, allowing them to diversify risks in line with their risk profile for a relatively small invested capital.

### Real estate funds

Real estate funds typically buy investment properties such as apartment blocks or commercial premises. They offer diversification benefits thanks to their low correlation (see Glossary) to bonds and shares. The downside is poor liquidity, which may limit the scope for redeeming units of real estate funds. For more information on real estate investments, see Section 4.3.10.4.

### Commodity funds

Commodity funds make it possible to invest in all the major commodities. This allows investors to diversify their portfolios and enjoy protection against inflation by investing in real assets. The risks involved are in particular the high volatility (see Glossary) of some commodity prices, general risks arising from unexpected supply/demand situations and geopolitical risks. Commodity funds are suited to investors who are prepared to accept large price fluctuations. For more information on commodity investments, see Section 4.3.10.5.

### Liquid alternatives

Liquid alternatives are regulated investment funds with alternative investment strategies that differ from those of traditional funds but still meet the requirements of the EU's UCITS Directive. These strategies are more like those of offshore funds and hedge funds and use a variety of investment instruments. For more information on offshore funds and hedge funds, see Section 4.3.10. Liquid alternatives are more strictly regulated, more transparent and more liquid than offshore funds and hedge funds. Investors can use them to diversify their investment strategy thanks to their low correlation to equity and bond markets. They are also a means of investing in alternative risk premiums, which are largely free of traditional market risks.

### Actively managed investment funds

With actively managed investment funds, the fund manager chooses the mix of asset classes and individual securities in accordance with specific criteria, continually monitors the portfolio and adjusts it as required.

The fund's performance is measured against a reference index known as the benchmark, and the fund manager attempts to add value for investors by constructing a portfolio that outperforms the benchmark.

### Passively managed investment funds and ETFs

Passively managed investment funds, also called index funds, track a market index, which significantly reduces management costs. Their investment decisions are essentially determined by changes in the index. Passively managed investment funds thus offer a simple and cost-effective way of ensuring broad diversification.

Exchange-traded funds (ETFs) normally track an index, e.g. a share, bond, money market, real estate, hedge fund, currency or commodity index. They offer the advantage of being easy to trade.

### Funds of funds and multi-manager funds

Investment funds that invest in other funds (target funds) rather than individual securities are known as funds of funds. The target funds can invest in a wide range of securities.

Multi-manager funds spread their investments among a number of fund managers covering different investment styles, markets and financial instruments.

Investors can achieve a higher level of risk diversification by investing in funds of funds and multi-manager funds, but the costs are generally higher due to the costs generated by the various underlying funds.

Investors should also bear in mind that certain categories of funds of funds and multi-manager funds domiciled in countries with strict legislation on collective investment schemes may follow strategies that are to some extent similar to those of offshore and hedge funds (see Section 4.3.10).

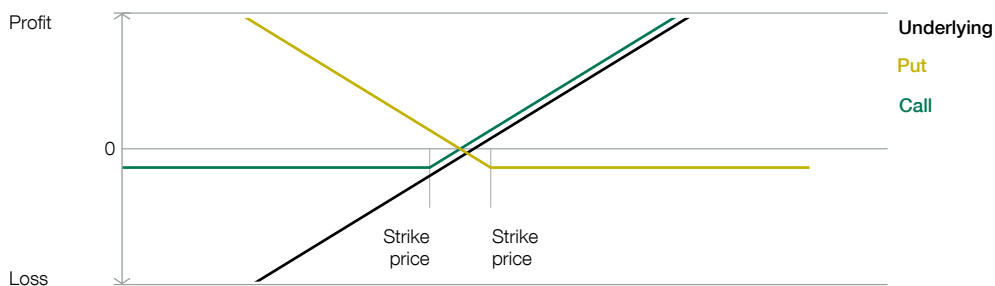
## 4.3.5 Options

### What they are

An option is an agreement between a buyer and a seller conferring the right to buy or sell a specific underlying asset (often referred to simply as the “underlying”) at a predefined price at or before a specific point in time (the expiry date). The agreed price applies regardless of the current market value on the expiry date.

As the buyer of an option, you have the right to buy a specified amount of an underlying from the seller (call option) or sell it to the seller (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.

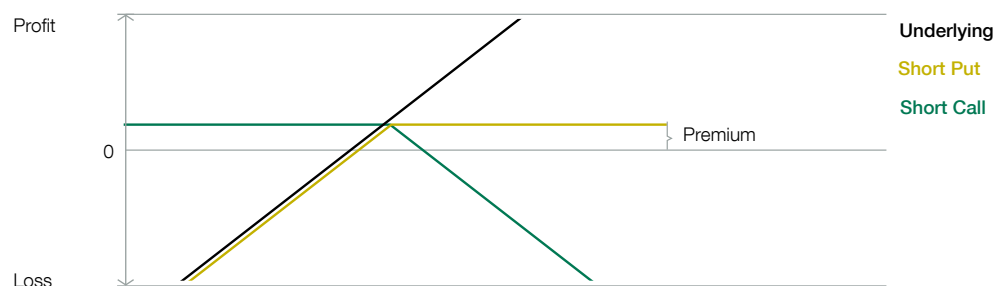
Fig. 2 – Example: Buyer



Source: SBA

As the seller (writer) of an option, you must sell the underlying to the buyer at the strike price (call option) or buy the underlying from them at the strike price (put option) up until the expiration date, irrespective of the market value of the underlying asset at the time, if they choose to exercise the option.

Fig. 3 – Example: Writer



Source: SBA

#### Various types of underlying are possible:

- Investment assets, e.g. shares, bonds, precious metals, other commodities, etc.
- Other assets, e.g. currencies, rates (exchange or interest rates), or indices
- Derivatives
- Events, e.g. credit incidents, inflation, unemployment, natural (e.g. weather) phenomena, or
- Any combination of the above

#### “American-style” options

“American-style” options can normally be exercised on any trading day up to the expiration date.

#### “European-style” options

“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).

#### Physical settlement vs. cash settlement

Where a call option provides for physical settlement, you can require the seller of the option (writer) 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.

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 current market value of the underlying asset.

#### Price of an option

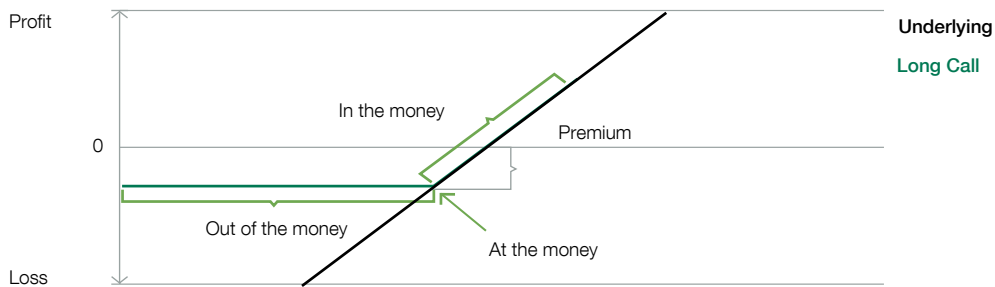
The price of an option is closely linked to that of the underlying. An option can be “in the money”, “out of the money”, or “at the money”:

**In the money:** 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. If an option is in the money before expiry, it has an intrinsic value.

**Out of the money:** 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.

**At the money:** 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.

Fig. 4 – Example: Call option in the money, at the money, out of the money



Source: SBA

### Value of an option

The price of an option depends on its intrinsic value and on what is referred to as the time value (see Glossary). The latter depends on a variety of factors, including the remaining life of the option and the volatility of the underlying. The time value reflects the chance that the option will be in the money. It is higher for options with a long duration and a very volatile underlying and for options that are at the money. As mentioned above, an option can be in the money, out of the money or at the money.

### Types of options

#### Warrant

Warrants are options in securitised form that are traded on an exchange or over the counter. Exchange-traded warrants frequently involve bilateral settlement without the involvement of a central clearing house. Normal options are standardised as regards the strike price, ratio of options to underlying and term. With a warrant, the issuer can determine these itself, however it usually does in line with investors' preferences in order to ensure sufficient demand for the warrant.

#### Exchange-traded options

Exchange-traded options are not issued as securities but are traded on an exchange and settled via a central clearing house. The exchange or central clearing house is a counterparty (see Glossary) in the transaction, whereas in a warrant transaction the issuer is the counterparty itself.

#### Over-the-counter (OTC) options

OTC options are neither securitised nor traded on-exchange. They are agreed directly off-exchange between the seller and the buyer.

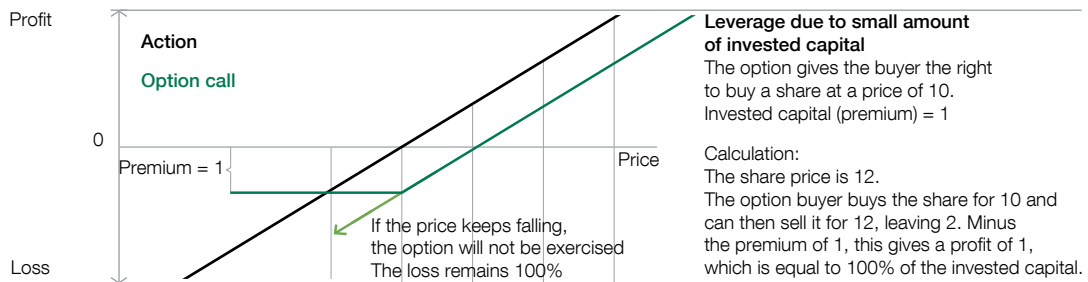
Investors who wish to cancel (close out) an option of this type before the expiry date must make a corresponding offsetting trade with the counterparty.

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.

### Leverage effect

An option costs less than its underlying, but its gains and losses are heavily dependent on the underlying. Any change in the market value of the underlying will result in a greater change in the price of the option. This is known as the leverage effect. It allows investors to profit disproportionately from increases (call option) or decreases (put option) in the price of the underlying.

Fig. 5 – Example: Buying a call option



Share price	Share profit/loss	Option profit/loss
10	0%	-100%
11	+10%	0%
12	+20%	+100%
13	+30%	+200%

Source: SBA

### Margin cover

If you sell 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 or margin is determined by the financial intermediary. The exchange stipulates a minimum margin for traded options.

**CAUTION:** If the margin cover proves insufficient, the financial intermediary can require you to provide additional collateral (via a margin call). If the investor cannot provide the collateral quickly enough, the financial intermediary may unilaterally close out the option, in which case the investor loses the opportunity to profit from a favourable trend in the underlying up to expiry.

### Covered options

With traditional covered options, the investor must deposit the underlying as collateral and is also referred to as the covered writer.

This means that with a covered option (sale of a covered call), you purchase an underlying (equity, bond or currency) and simultaneously write a call option on that same underlying. In return, you are paid a premium, which limits your loss in the event of a fall in the market value of the underlying asset. By the same token, however, your potential return from any increase in the asset's market value is limited to gains up to the option's strike price. Traditional covered options require that the underlying asset be lodged as collateral, which makes you the covered writer.

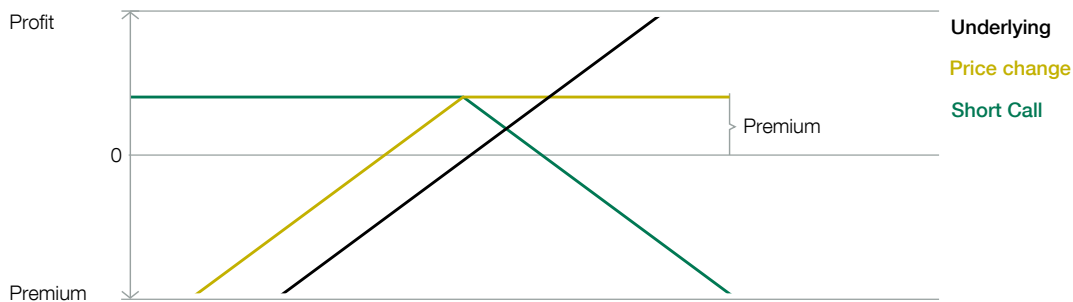
Synthetic covered options are based on the idea of replicating traditional covered options. However, this is achieved by means of only one transaction. Both the purchase of the underlying and the writing of the call option are carried out simultaneously using derivatives. The purchase price of this type of financial instrument is equal to the price of the underlying minus the premium received on selling the call option. Hence, the synthetic product is sold more cheaply than its underlying.

### Risks associated with covered options

Covered options do not contain a hedge against falls in the market value of the underlying. However, by writing a call option (traditional covered option) or by calculating the return from the sale of a call option into the product price (synthetic covered option), any loss in market value of the underlying has less impact than it would in the case of a direct investment. In effect, the option premium thereby limits any loss in the market value of the underlying. Either cash settlement or physical delivery of the underlying takes place on the expiration date. If the market value of the underlying on expiration is higher than the strike price, the holder of an option with cash settlement is paid a specified cash amount as settlement.

**CAUTION:** If, however, the market value of the underlying is lower than the strike price, the holder of an option with physical settlement receives physical delivery of the underlying asset. In this case, the option holder bears the full risk associated with the underlying.

Fig. 6 – Example: Sale of a covered call option



Source: SBA

### Risks associated with options

Different types of option are subject to different risks.

Generally speaking, if the market value of the underlying falls, so does the value of a call option. The value of a put option, meanwhile, tends to fall if the market value of the underlying rises. Normally, the less an option is in the money, the larger the fall in the option's value. In such cases, the value normally falls much more sharply close to the expiry date.

The value of a call option can drop even when the market value of the underlying remains unchanged or rises. This is the case, for instance, when the time value of the option (see Glossary) falls, when supply and demand factors are unfavourable or when changes in volatility have a greater effect than changes in market value. Put options behave in precisely the opposite manner.

**CAUTION:** It must be borne in mind that options can lose value or even become completely worthless as their expiry date approaches. From the buyer's point of view, this means a loss equal to the premium paid for the option. The loss risk for the seller of a call option is theoretically unlimited.

### Special risks

#### As the seller (writer) of a call option

##### Risks you face as the seller (writer) 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. Otherwise, you are essentially subject to the same risks as when writing an uncovered call option (see below).



### **Risks you face as the seller (writer) of an uncovered call option**

If, as 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.

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

With American-style options in particular, investors must also be prepared for the possibility of the option being exercised in the midst of highly unfavourable market conditions, resulting in a heavy loss. Where there is an obligation to provide physical delivery, it may be very expensive or even impossible to acquire the underlying.

American options on equities with physical delivery are liable to be exercised as the dividend date approaches.

**CAUTION:** You must also 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.

### **As the seller (writer) of a put option**

#### **Risks you face as the seller (writer) 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 the seller. The loss risk in this case is made up of the difference between these two values minus the premium the buyer paid for the option.

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

**CAUTION:** 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 the worst case lose all the capital you invested. The maximum loss is equal to the strike price multiplied by the quantity of underlying that must be bought.

### **With covered options**

Covered options do not contain a hedge against any falls in the market value of the underlying. However, writing a traditional, covered call option or factoring the proceeds from writing a call option into the price of a synthetic covered option reduces any loss on the underlying's market value compared with a direct investment in the underlying. In effect, the option premium limits any loss on the market value of the underlying.

Either cash settlement or physical delivery of the underlying takes place on the expiry date.

If the market value of the underlying on expiry is higher than the strike price, the holder of an option with cash settlement receives a specified cash amount.

**CAUTION:** If, however, the market value of the underlying is lower than the strike price, the holder of an option with physical settlement receives physical delivery of the underlying asset. In this case, the option holder bears the full risk associated with the underlying.

## Option strategies and special options

### What they are

If two or more options with the same underlying but strategic differences – e.g. in terms of type (call or put), ratio, strike price, expiry or transaction (purchase or sale) – are combined, this is referred to as an option strategy.

**CAUTION:** Given the many possible combinations, the risks involved in any particular case cannot be covered in every detail in this brochure. Investors should find out about the specific risks by reading the product's legal documentation or Key Information Document before selecting a strategy.

### Exotic options

Unlike the “plain vanilla” put and call options described above, exotic options are linked to additional conditions and agreements. They come in the form of tailor-made OTC options (see Glossary) or as warrants.

Given the special composition of exotic options, their price movements can vary markedly from those of their “plain vanilla” cousins. There is no limit to the possible structures for exotic options. The risks associated with individual exotic options cannot be described exhaustively here.

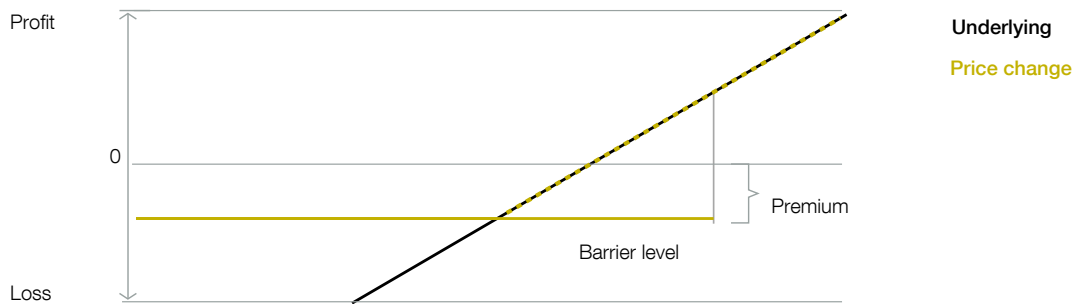
**CAUTION:** You must be aware that larger transactions can trigger price movements even shortly before expiration and that these can render an option worthless. Before buying or selling any exotic options, be sure to seek comprehensive advice about the particular risks involved.

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

### Path-dependent options

With path-dependent options, in contrast to “plain vanilla” options, the market value of the underlying is not only important when the option expires or is exercised. Fluctuations in the market value of the underlying during the term of the option must also be taken into account when contemplating such an investment. The main types of path-dependent options are outlined below.

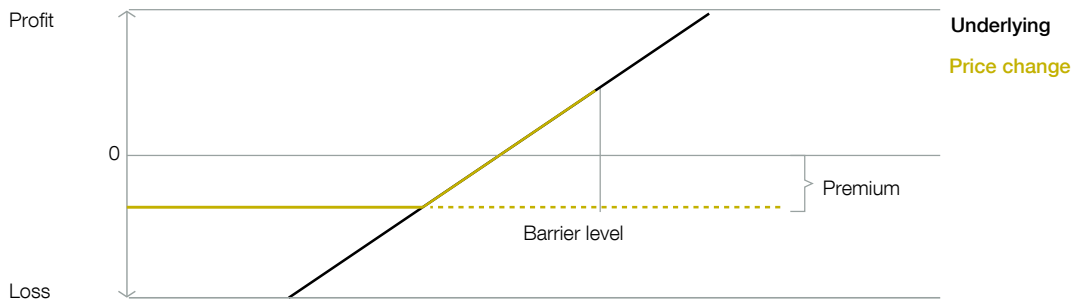
Fig. 7 – Knock-in barrier option



Source: SBA

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.

Fig. 8 – Knock-out barrier option



Source: SBA

Exercise rights for knock-out barrier options become invalid if the market value of the underlying reaches a fixed threshold (barrier) within a specified 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 or knock-out barrier options.

**CAUTION:** When buying a barrier option, you must be aware that your exercise rights only arise 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).

### Barrier option accumulator structures

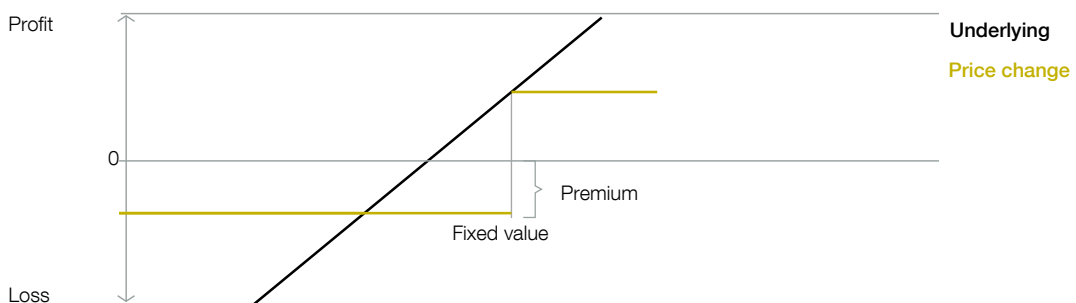
An accumulator structure comprises a series of barrier options allowing the investor to buy (accumulate) a specific nominal value of a currency or a specific quantity of an underlying at a predefined strike price during a specific period. A decumulator structure is the opposite, allowing the investor to sell (decumulate) the underlying.

As long as the underlying does not break through the knock-out barrier, the investor accumulates the predefined quantity of the underlying in stages up to the end of the term. The investor has full power of disposal over the underlying (and can therefore sell it) as soon as each option is exercised. If the knock-out barrier is reached, the whole structure expires prematurely, and no further options can be exercised.

Accumulator structures often include an additional multiplier, e.g. a multiple of 1.5 or 2 times the nominal quantity of the underlying is bought, provided the current market value (spot price) is below the strike price.

A lower strike price compensates investors for the uncertainty over the effective accumulation quantity, which depends on the performance of the underlying and the term of the structure. Investors can thus benefit from a lower purchase price.

Fig. 9 – Payout option



Source: SBA

Payout options entitle investors to receive a premium that is fixed 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 period (one-touch digital option) or precisely on the day of expiration (all-or-nothing option).

For the one-touch digital option, the premium is paid either immediately when the barrier is reached or on the expiry date (lock-in option).

If the value is not reached during the term, the option expires with no value.

With lock-out (or “no-touch”) options, you only receive the fixed payment if the market value of the underlying does not reach the agreed barrier during a specified period. If the value is reached, the option expires with no value.

**CAUTION: If you sell a payout option you must pay the fixed amount if the market value of the underlying reaches or fails to reach the barrier, regardless of whether or to what extent the option is in the money when it is exercised or expires. This means that the amount owed can be considerably larger than the option’s intrinsic value.**

### Asian options

Asian options involve calculating the average market value of the underlying over a specified time period. This average is used to determine the underlying’s value in the case of an average-rate option and to calculate the strike price in the case of an average-strike option.

**CAUTION: 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.**

**CAUTION: For an average-strike option, the average strike price of a call option can be considerably higher than the price originally set. Conversely, the strike price of a put option can 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 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 of a price lookback option remains unchanged. Instead, the option value is calculated from the highest value (call option) or the lowest value (put option) of the underlying.

**CAUTION: 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. If you sell 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).

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

Fig. 10 – Contingent option



Source: ASB

## 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 the option has is locked in when this adjustment is made, and these lock-ins are accrued throughout the option’s term.

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.

**CAUTION:** If you sell 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. It must be borne in mind that the lock-in amount may be considerably higher than the option’s intrinsic value on the expiry date.

## Options on multiple underlyings

Spread and outperformance options are two examples of options on multiple underlyings. Both have two underlyings.

The value of a spread option is calculated from the absolute difference in the performance of the two underlyings.

The value of an outperformance option, meanwhile, is calculated from the relative difference, i.e. the percentage by which one underlying outperforms the other.

**CAUTION:** 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

Compound options have an option as their underlying, i.e. they are options on options. Compound options can have an especially large leverage effect.

**CAUTION:** Investors selling (writing) them must be prepared for very high liabilities.

### Credit default options

Credit default options transfer a credit risk from the original risk-taker (risk seller) to a third party (risk buyer), who receives a premium in return. If the predefined credit event occurs, the risk buyer is obliged to pay a cash settlement or take on the non-performing loan (or another delivery obligation) by way of physical settlement at a predetermined price. Credit default options are a form of credit derivatives.

**CAUTION:** The risk of chain reactions on the credit market is high and can easily be underestimated. There is also the risk that a 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 or over the longer term or perhaps even that it cannot be sold at all.

Securities, and especially derivatives, entail financial risks. Derivatives are often composed of a number of financial instruments, which sometimes makes them difficult to understand. This is particularly true for “exotic” options. This brochure explains these financial instruments and their associated risks. However, it is no substitute for the product descriptions provided by issuers and financial intermediaries. UBP will be pleased to provide any further information.

### Limited and unlimited risk

There are basically two distinct types of financial instruments: those with limited risk and those with unlimited risk. The purchase of equities or options involves limited risk. At worst, you will lose the entire amount of your invested capital and not make a profit.

**CAUTION:** Certain types of derivatives can require an additional outlay of capital over and above the original investment. The obligation to respond to margin calls can amount to several times the purchase price of the securities. Unlimited risk is particularly associated with:

- selling uncovered call options
- selling forwards and futures

When selling a put option, on the other hand, the seller incurs a limited risk equal to the strike price of the underlying.

## 4.3.6 Swaps

### What they are

A swap is a contract between two counterparties negotiated over the counter to exchange future cash flows over a specified period; it only involves an exchange of the difference in value between a fixed and a variable amount.

### Your duties and obligations in a swap transaction

The floating amount payer has to pay the variable amount of the swap. The fixed amount payer has to pay the fixed amount of the swap.

The cash flows (variable and fixed amounts) are based on a theoretical principal sum (the notional) on one or several predetermined dates during the life of the contract, or on the expiration date.

## The possible underlyings for swaps

The underlyings for a swap can be:

- assets (equities, bonds, precious metals and other commodities)
- benchmark rates such as currencies, interest rates and indices
- derivatives
- any tangible or intangible item (inflation, unemployment, the weather, natural risks, etc.), or
- any combination of the above

## Physical settlement vs. cash settlement

For swaps with physical settlement, you can require the swap counterparty to deliver the underlying on expiration, or on the payment dates if there are several of them.

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 current market value of the underlying asset.

## Types of swaps

The most common swap contracts are:

- “Plain vanilla” interest rate swaps which exchange the interest on a notional variable-rate loan or deposit for interest at a fixed rate
- Currency swaps, in which there is an exchange of the interest and principal on the maturity of a loan or deposit in one currency for its value in another
- Credit default swaps, in which there is an exchange of protection on the credit risk of the issuer of a bond for periodic and regular payments over the life of the swap
- Commodity swaps, which exchange a fixed price, calculated when the swap contract is signed, for a variable price, normally calculated as the average of an index for a future period

However, there are many other types of swaps, including:

- Cross-currency swaps, or currency interest rate swaps (CIRS) in which there is an exchange of medium- or long-term interest rates in two different currencies
- Standard basis swaps, which exchange two variable rates indexed to short-term benchmark rates in the same currency or in two different currencies
- Constant maturity interest rate swaps, which allow a variable rate indexed to a short-term interest rate to be exchanged for another variable rate indexed to a medium- or long-term rate with a constant maturity (i.e. the maturity of the interest rate is repeatedly converted into medium or long term)
- Asset swaps, a combination of two products: a fixed-rate bond and a corresponding swap (an over-the-counter contract with an exchange of fixed interest for variable interest between two counterparties in accordance with a predetermined timetable); the fixed leg of the swap replicates the precise characteristics of the bond so that the asset swap enables a synthetic variable-rate bond to be created out of a fixed-rate bond
- Equity swaps
- Variance swaps and volatility swaps, which pay the volatility of an underlying
- Correlation swaps, which pay the correlation of a basket of assets – i.e. correlation either between the assets themselves or against a benchmark
- Inflation swaps, in which a fixed or variable rate is swapped for an inflation rate
- Total-return swaps, which exchange the income and market risk of the value of two different assets over a given period – for example: One leg of the swap is a variable short-term rate, the other is a fixed amount linked to an index or any type of financial investment (an equity, a bond, etc.)

### Margin cover

When you sign a swap contract, you will have to deposit collateral for the entire duration of the contract in the form of a corresponding number of underlyings or other assets to cover the appreciation or depreciation of that contract or its underlying. The amount of the collateral required (the margin) is defined by the counterparty.

**CAUTION: If the margin cover proves insufficient, the counterparty can require you to provide additional collateral (via a margin call).**

### Risks associated with swaps

The principal risk in a swap is counterparty risk. However, margin calls or the deposit of collateral can virtually eliminate this risk.

Counterparty risk is the potential loss incurred by the party to the swap as a result of a future default of his counterparty. This risk covers two intrinsically different risks: settlement risk and credit risk.

Settlement risk is involved in any market transaction involving a simultaneous exchange of financial flows. Settlement risk arises from the failure to make the simultaneous transfers over the time required to complete the transaction.

Credit risk can be defined as the total loss incurred in a transaction if the counterparty defaults. It is also sometimes referred to as "signature risk".

However, in a floating-rate swap (i.e. one in which payment of the financial flows is made on regular predetermined dates and not on maturity), in the event of default by the counterparty, the only loss will be the latest performance, as the non-defaulting party will stop paying if the (defaulting) counterparty does not meet its contractual obligations.

**CAUTION: For each type of swap, there is a specific risk linked to the underlying or to the financial flows exchanged. UBP will be pleased to provide any further information.**

For instance, a variable-rate borrower wishes to fix their cost of borrowing, and signs a swap contract as the payer of a fixed rate. Having previously been liable for a variable rate, they are now liable for a fixed rate, regardless of the level of the variable rate. Thus, the borrower has hedged their risk of an increase in the cost of borrowing. The risk for the party paying the fixed rate is of not receiving the benefit of any fall in the variable rate and therefore missing the opportunity of cheaper borrowing. Conversely, the counterparty paying the variable rate bears the risk of an increase in interest rates.

## 4.3.7 Forward and futures transactions

### The obligations you have with forwards and futures

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. Unlike with options, which (for the buyer at least) only give rise to rights, forwards and futures involve both parties entering into obligations. You do not have to pay a premium when the contract is concluded.

**CAUTION: Forwards and futures can involve special risks. You should therefore only make investments 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.**

### The difference between forwards and futures

Futures are traded on an exchange. They take the form of contracts in which the quantity of the underlying and the expiration date are standardised.

Forwards are not traded on an exchange; so 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 seller.



## Underlyings for forwards and futures

The most common underlyings providing a basis for forwards and futures are:

- assets such as equities, bonds, precious metals and other commodities
- benchmark rates such as currencies, interest rates and indices
- any other asset

## Margins: Initial and variation margins

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 Bank for the entire life of the contract.

**CAUTION:** In the event of a book loss, the variation margin can be several times larger than the initial margin.

## Closing out transactions

You can close out the transaction at any time before the expiry date or the next possible delivery date (“first notice day”), in normal market conditions. The nature of the closing out (see Glossary) will depend on the type of contract and the practice of the exchange, particularly with regard to price limits. You either “sell” the contract or agree an offsetting trade with identical or reversed terms. Concluding such an offsetting trade means that the obligations to deliver and receive cancel one another out, but the initial contract is not cancelled: two contracts with opposite strategies are open.

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

## Settling transactions

If the underlying of a forward contract is a physical asset, the contract may provide for physical delivery or a cash payment. Generally, the asset is delivered physically. 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, except for futures on benchmark rates where, at the end of the contract, there is a physical delivery of bonds (the least expensive, regardless of the reference currency or issuer) in accordance with the terms of the contract.

## Special risks 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.

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

**CAUTION:** 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 may set price limits for certain contracts. Find out about this before committing to forward and 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.

**CAUTION:** 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.

#### **Special factors that apply to OTC forwards**

The market for standardised OTC forwards is transparent and liquid. Contracts can therefore normally be closed out without difficulty. There is no actual market for OTC forwards agreed individually, so the positions they entail may only be closed out with the agreement of the counterparty.

#### **Special factors that 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 carrying out combinations, you must therefore find out from the Bank about the special risks involved.

Given the many possible combinations, we cannot go into detail in this brochure about the risks involved in any particular case. Before making a purchase, be sure to seek comprehensive advice.

### **4.3.8 Structured products**

#### **What they are**

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. They can be static or actively managed by the issuer of the structured product or by a third party. Dividends may or may not be reinvested. The issuer of a structured product is liable with their own assets, as is any guarantor to the extent of the guarantee. Unlike with collective investment schemes (investment funds), the underlying assets do not benefit from special protection. Structured products are not categorised as collective investments under the European UCITS Directive. The issuer is liable with his or her own assets, 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).

The buyer of a structured product does not normally acquire voting rights and may not be entitled to dividends on the underlying asset. Participation products are often different in this respect, and include a net dividend after deduction of withholding tax. This net dividend may be wholly or partly retained (reinvested), periodically distributed or incorporated as a discount (see Glossary) into the issue price.

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

#### **Selling a structured product**

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 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.

#### **Issuer risk**

You bear the risk that the debtor of a structured product may become insolvent (issuer risk). The instrument's value is therefore dependent not only on the performance of the underlying asset but also on the creditworthiness of the issuer, which may change over the term of the structured product. In the event of a default of the issuer, all or part of the investment may be lost, regardless of the type of product.

## Special risks 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.

## Types of structured products

### Common types of structured products

With such large numbers of structured products available on the market, this brochure does not claim to cover all risks of investing in this type of instrument. We illustrate below the characteristics and risks associated with investment in the structured products most frequently used by our Group.

- Capital protection products
- Yield enhancement products
- Participation products
- Leverage products
- Investment products with a reference entity

**CAUTION:** 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.

### a. Capital protection products

#### Types of capital protection

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. This percentage defines the level capital protection. However, capital protection only applies at the end of the term and may, depending on the product conditions, be less than 100% of the invested capital. Only financial instruments offering 100% capital protection guarantee that the investor will receive the full nominal value on expiry. All other products offer only a partial guarantee.

The accepted standard in the structured products market is that a financial instrument can be described as a capital-protection product if it offers at least 90% protection. If it is lower, the term “minimum repayment” is normally used, and the instrument is classified as a yield-enhancement or participation product.

**CAUTION:** 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.

#### How capital protection products work

Structured products with capital protection generally 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 only covers part of the nominal value, but it defines the minimum repayment the investor receives on expiry, regardless of how the participation component performs.

#### 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 the capital protection relates 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.

### Extent to which the invested capital is protected

The capital protection component can be less than 100% of the capital invested, depending on the financial instrument. Capital protection does not therefore mean 100% repayment of the nominal value or capital outlay for all financial instruments. Structured products with capital protection may yield a lower return than a direct investment in the underlying, because the protection comes at a cost.

### Validity of the capital protection if you sell the product during its term

**CAUTION:** 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 if you keep the product until the redemption date.

### Purpose of the participation component

The participation component determines to what extent 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 offer unlimited potential participation (those without a cap). Others require the market value of the underlying to touch, rise above or fall below a specific barrier before a profit can be made.

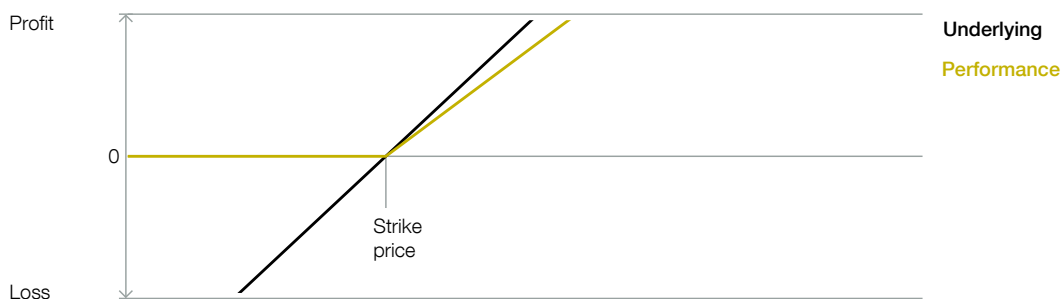
### Special risks you need to bear in mind

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 be zero.

### Maximum possible loss

**CAUTION:** The maximum loss on a structured product with capital protection is limited to the difference between the purchase price and the capital protection, provided the product is held until expiry. 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. Please be aware that there is also issuer risk, against which capital protection offers no protection. This means that if the debtor of a structured product becomes insolvent, some or all of the capital invested may still be lost.

Fig. 11 – Example: Capital protection with participation



In a capital protection product with participation, the buyer participates in any further rise in the market price of an underlying once it reaches the strike price.

Source: Swiss Structured Products Association (SSPA)

Fig. 12 – Example: Barrier capital protection

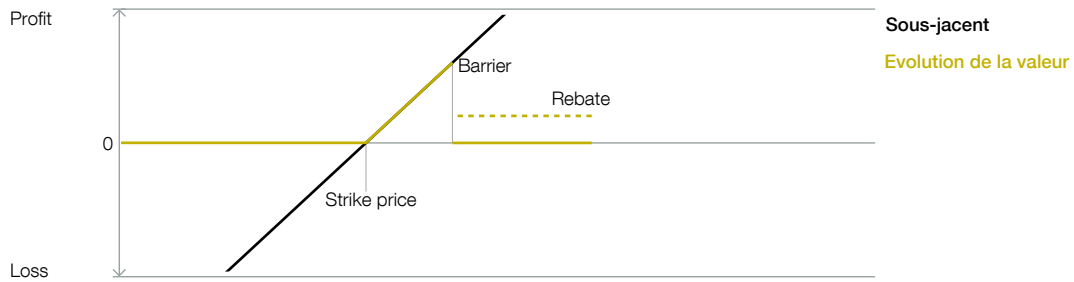
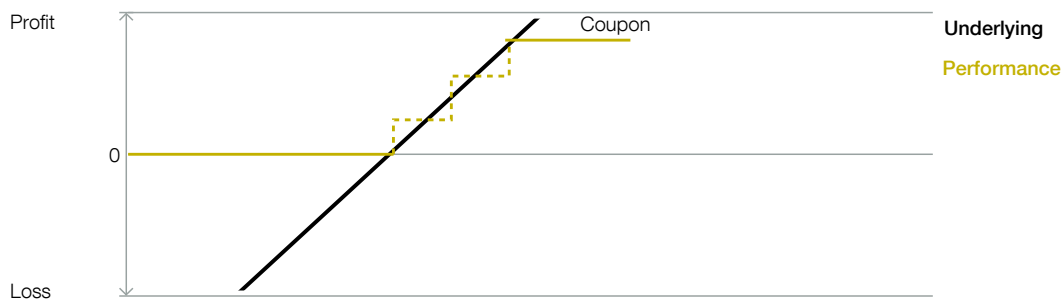


Fig. 13 – Example: Capital protection with coupon



Source: Swiss Structured Products Association (SSPA)

## b. Yield enhancement products

### What they are

Structured products with yield enhancement consist of two elements, such as a fixed-income investment and an option (mainly on equities 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) up to the cap. However, these financial instruments offer no or only conditional capital protection. They are generally based on constant or slightly rising underlyings. The interest paid or discount on the issue price offers you a higher return than on 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. Conversely if it falls sharply, you receive a cash settlement or delivery of the underlying on expiry, and so will also participate in the negative performance of the underlying. However, the loss incurred is reduced by the interest payment received during the term of the product, unless a discount was granted on the issue price.

### Special risks you need to bear in mind

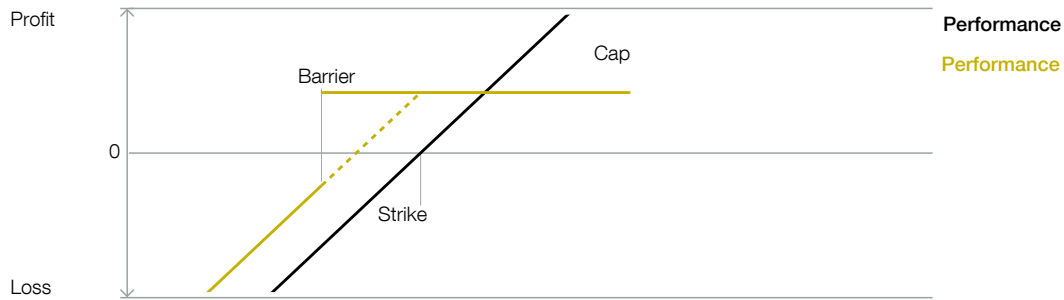
Many products with yield enhancement refer to several underlyings. You as investor receive the security with the worst performance on expiration (either physically or in the form of cash) if the underlying touches, rises above or falls below a predefined barrier during the term of the financial instrument. If the performance of the underlying is unfavourable, the financial instrument can trade some way below the issue price during its term even if the barrier has not yet been reached, exceeded or undershot.

The level of interest is directly linked to the level of the barrier, the number of underlyings and the term of the yield enhancement product. 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.

### Maximum possible loss

**CAUTION:** When you invest in a structured product with yield enhancement, you could in the worst case lose the entire capital that you have invested, apart from the coupon which is guaranteed (except in the event of the issuer's default).

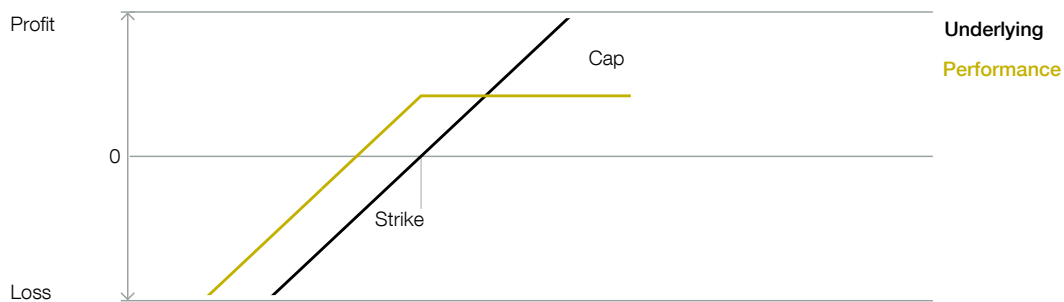
Fig. 14 – Example: Yield enhancement with barrier and cap



As long as the barrier is never touched, the maximum repayment (cap) or the nominal value plus a coupon is repaid. If the barrier is touched, the product is converted into a pure cap product.

Source: Swiss Structured Products Association (SSPA)

Fig. 15 – Example: Yield enhancement with cap



Once the strike price is reached, the maximum amount (cap) is repaid. Up to that level, the risk of loss compared with the underlying is reduced by the payment of a coupon or grant of a discount.

Source: Swiss Structured Products Association (SSPA)

### c. Participation structured products

#### What they are

Structured products with participation enable you to participate in the performance of one or more underlyings. Often they have neither a profit ceiling nor capital protection. However, they may offer a conditional minimum repayment, in which case 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”).

If it reaches, rises above or falls below the barrier, the minimum repayment is forfeited and your capital is no longer protected. Repayment is then dependent on the performance of one or more underlyings.

### Special risks you need to bear in mind

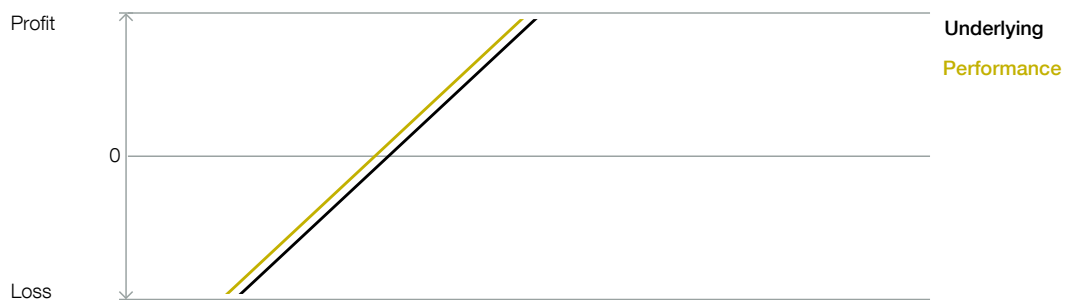
The risk of a structured product with participation is generally the same as that of the underlying. Unlike with a direct investment, however, you do not receive voting rights and you are not entitled to a dividend. You do, though, bear the credit risk of the product's issuer.

Many structured products with participation refer to several underlyings. You as investor receive the security with the worst (or sometimes best) 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 underlying is delivered or a cash settlement is paid if 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. An investor who has accepted a higher level of risk when choosing the barrier will participate with a larger amount.

### Maximum possible loss

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

Fig. 16 – Example: Standard participation



The investor participates 1:1 in the performance of the underlying.

Source: Swiss Structured Products Association (SSPA)

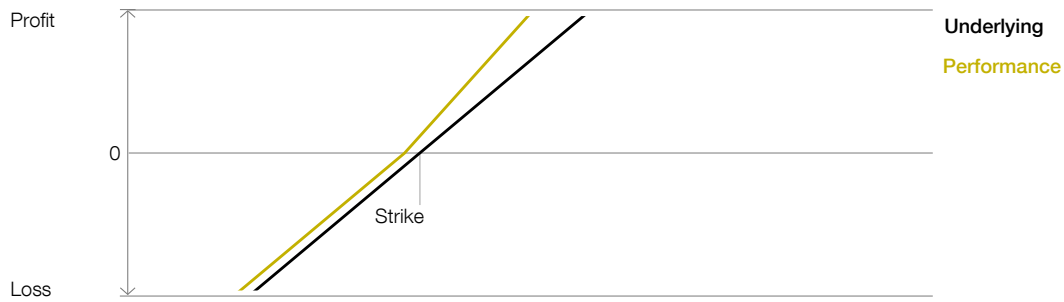
Fig. 17 – Example: Participation with barrier



The investor participates in the performance of the underlying with a minimal repayment until the barrier is reached. If the barrier is touched, the product is converted into a standard participation product.

Source: Swiss Structured Products Association (SSPA)

Fig. 18 – Example: Participation with outperformance



The investor participates 1:1 in the performance of the underlying until the strike price is reached. Thereafter, they participate disproportionately in the positive or negative performance of the underlying.

Source: Swiss Structured Products Association (SSPA)

#### d. Leverage products

##### What they are

Structured products with leverage enable you to achieve a leverage effect by investing less capital than you would have to if you invested directly in the underlying. This means you can benefit from short-term trends while committing very little cash or only a fraction of the face value.

Leverage products are normally regarded as a category of structured products, but this brochure treats them as a separate product class because they differ significantly from other types of structured products. Whereas structured products are usually a combination of a conventional investment (such as a share or bond) and a derivative, leverage products “only” consist of a derivative or a combination of derivatives. Both leverage products and structured products legally constitute a debt instrument with derivative character, meaning that they are subject to a credit risk.

Leverage products are especially suitable for risk-friendly investors seeking to speculate over the short term and for strategically hedging an existing investment or portfolio.

Leverage products are geared to either investing speculatively or hedging risks. The leverage consists in the fact that investors can participate disproportionately from rising or falling prices with a relatively small amount of invested capital. It is thus possible to profit from short-term trends in either direction.

##### Special risks you need to bear in mind

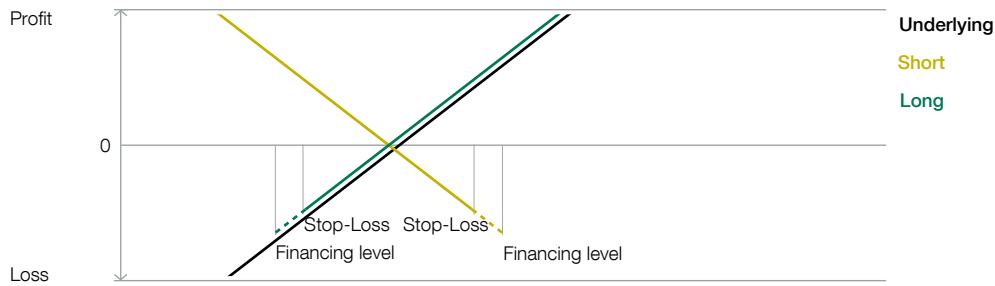
Because of the leverage effect, you need to carefully and regularly monitor the underlying, since structured products with leverage can produce a profit or loss proportionate to the amount of leverage used.

##### Maximum possible loss

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



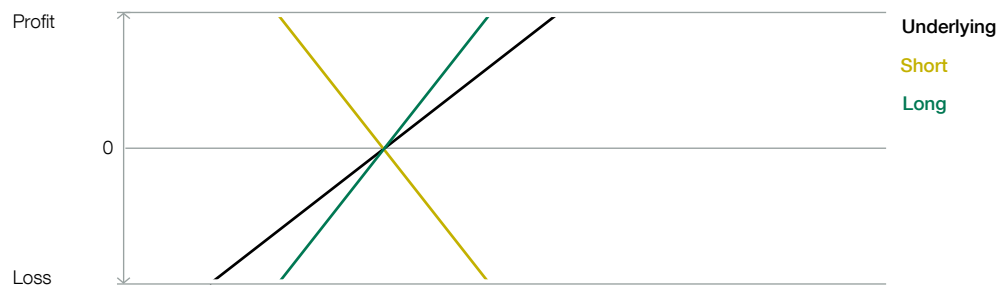
Fig. 19 – Example: Mini-future



With a mini-future, investors participate in the price of the underlying on a leveraged basis with a small amount of invested capital, provided the price remains above a stop-loss level.

Source: Swiss Structured Products Association (SSPA)

Fig. 20 – Example: Constant leverage certificate



With a constant leverage certificate, investors participate in the price of the underlying on a leveraged basis and thus profit disproportionately from rising (long) or falling (short) prices.

Source: Swiss Structured Products Association (SSPA)

### e. Reference entity certificates

#### What they are

Investment products with a reference entity are referred to as reference entity certificates. Normally they are variants on a conventional capital protection, yield enhancement or participation product with the basic structure extended to include an additional reference (corporate or government) bond. Repayment depends in particular on the non-occurrence of a credit event involving the reference entity, as defined in the relevant product description. In the absence of such an event, reference entity certificates work in the same way as comparable capital protection, yield enhancement or participation products. Owing to the additional risk, these products offer better conditions, such as higher coupons.

If a relevant credit event occurs, the financial instrument may fall due and be repaid before expiry. The repayment amount is related to the credit event, and may be zero.

#### Special risks you need to bear in mind

The risk of a reference entity certificate depends not just on the normal risks of comparable capital protection, yield enhancement or participation products and the issuer risk, but also on the creditworthiness of the reference entity. In the worst case, the entire capital invested can be lost.

### 4.3.9 Products used for financing or risk transfer

#### What they are

There are some financial instruments 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 (see Glossary).

The financial instruments discussed in this section have the same or similar profit and loss structures as certain conventional financial instruments (equities or bonds).

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

#### Special risks you need to bear in mind

Credit and catastrophe derivatives are subject to liquidity risks because a lack of trading may make it impossible to sell them before expiry. The risks associated with products used for financing or risk transfer 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.

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

#### Credit-linked notes (CLN)

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

**CAUTION:** Particular attention should be paid to the creditworthiness of the debtor to which the CLN is linked, as a credit event may render it worthless. There is an issuer risk (see Glossary), i.e. a credit risk of the issuing bank, just as with other structured products. There is also a leverage effect on fluctuations in the underlying and the creditworthiness of the issuer during the term. The secondary market for CLNs has limited liquidity, which may make it impossible for the investor to sell the CLN before the end of the term.

#### Collateralised debt obligations (CDO)

CDO are bonds backed by a diversified debt portfolio – mostly loans, bonds or credit default swaps (CDS). They give you access to investments that are unattractive or even unattainable for private investors. Since CDO 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 debtor in the debt portfolio experiences a credit event, the equity-like tranches are affected first: they may be only partially redeemed, or not redeemed at all. If a number of debtors 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: they will receive a performance-related bonus and will often have a holding in the CDO themselves. 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.

**CAUTION:** CDO 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.

### Asset-backed securities (ABS)

With ABS, risks, for instance those attached to a group of debt claims, are 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). Many other types of ABS exist, and there is no standard structure or terminology: there are “collateralised debt obligations” (CDO) and “collateralised loan obligations” (CLO), etc. The individual components of the portfolio would be unattractive or even unobtainable in this form for individual investors, while 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.

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

**CAUTION: Credit bonds are often issued by particular types of offshore companies known as 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.**

#### Special risks you need to bear in mind

The risk level of ABSs always depends on the issuer – the SPV – as well as the quality of the portfolio and the specific structure of the security.

For example, if additional assets (e.g. blocked credit balances on reserve accounts) are created outside the portfolio to account for certain scenarios, these ensure the agreed payment flows as well as those that are important for the overall transaction. This reduces the risk of default on the payment flows considerably and also reduces the overall risk of default on the periodic interest payments or the repayment of the ABS at the end of its term. The SPV routinely issues several classes of ABS shares with different ranks, credit ratings and risk premiums. If it does not have sufficient funds to meet all its obligations when they fall due, the available funds are paid out by rank. The lower ranks bear any losses, while the higher ranks might be covered in full. In addition, ABS holders may be granted a security interest in the SPV’s assets, which could reduce their loss risk.

If the SPV is domiciled outside Switzerland, attention should be paid in particular to the issuer risk (see Glossary) and the quality of state supervision of SPVs in the domicile country. Classes with higher risk premiums (and thus higher yields) typically also have a higher risk of default than those with lower risk premiums.

#### 4.3.10 Alternative or non-traditional investments – offshore and hedge funds

##### What they are

Alternative or non-traditional investments are investments that do not fall within the traditional asset classes, such as equities, bonds or money market products.

##### What is meant by “offshore and hedge funds”

In general, a distinction is made between collective investment schemes (see Section 36) domiciled in countries with strict legislation – such as Switzerland or the EU – and those domiciled in countries with comparatively relaxed legislation – such as the Cayman Islands or British Virgin Islands.

The former are referred to as onshore funds, and the latter as offshore funds.

Offshore investments are often structured as funds or partnerships (such as limited partnerships) and domiciled in countries where legislation and supervision can be relatively weak. FINMA does not authorise such investments for sale to the general public in Switzerland.

**CAUTION: The legislation and supervision applying to offshore funds are much less strict than for traditional investments, which means that investors may enjoy less protection. They may find it difficult to enforce their rights, and problems and delays may occur when settling buy and sell orders for units of such funds.**

Many offshore funds are hedge funds. Offshore funds include a wide range of instruments and strategies. This section focuses on the classes that are most important in terms of risk information:

- Hedge funds
- Private equity
- Private debt
- Real estate
- Precious metals and other commodities

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

**CAUTION: Be sure to obtain comprehensive advice before investing in alternative or non-traditional investments, and examine the offering carefully**

#### 4.3.10.1 Hedge funds

##### What they are

Hedge funds are the best-known form of alternative or non-traditional investments. Despite what their name suggests, they 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 investment funds, investment companies and partnerships that use derivatives not just for hedging but also for investment, and 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.

##### Special risks you need to bear in mind

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 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.
- As with other types of collective investment schemes, a hedge fund's performance often depends on the expertise of a single person – the manager – or a small group of key individuals. Incorrect decisions or the loss of such people can have a direct impact on the hedge fund's performance. The dependence on a single fund manager can be reduced by, for example, investing in a fund of funds or multi-manager fund.

##### Funds of hedge funds or multi-manager hedge funds

Funds of funds invest their capital in a number of target funds. Multi-manager funds, meanwhile, are spread across a number of fund managers covering a range of investment styles, markets and financial instruments.

There are also structured products that you can use to invest in hedge funds or hedge fund indices.

## Hedge fund strategies

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

### - Equity hedge (“long”, “short”)

Equity hedge funds identify both undervalued shares – buy or long positions – and overvalued shares – sell or short positions – in specific regions and market segments. They seek to profit from closing out the positions at a profit sooner or later.

### - Arbitrage

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 event-driven strategies 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 macroeconomic 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.

## Risks associated with hedge funds

Offshore funds and hedge funds are subject to little or no regulation and minimal or no licensing requirements, and are not overseen by a supervisory authority.

The same applies to their managers. In particular, offshore and hedge funds are not subject to the numerous investor protection regulations that apply to approved collective investment schemes. These include rules on liquidity, redemption of fund units at any time, avoiding conflicts of interest, fair prices for fund units, disclosure obligations and limitations on borrowing. It is often difficult or even impossible to assert the rights of investors in offshore countries if problems occur with a fund.

The quality of self-imposed investment guidelines and the selection of independent third parties, the bank, custodian and auditors can vary. However, reputable fund managers meet international standards.

Offshore funds, and in particular hedge funds, make full use of their freedom to choose asset classes, markets – including high-risk countries – and trading methods. This can lead to greater diversification and, under certain circumstances, stable absolute returns, but they can use much more leverage than traditional authorised funds, and engage in complex investment transactions that are not permitted for traditional collective investments.

Because they are not subject to strict legislation, offshore funds are in principle less transparent. Their investment strategies are often highly complex and very difficult to understand. Investors are often insufficiently aware of changes of strategy that may lead to a significant increase in risk, or do not find out about them until it is too late. Managers frequently deliberately hold back information in order to exploit market inefficiencies and information advantages or to prevent certain insights into market mechanisms. The intransparency and complexity of many investment strategies is designed to prevent copying of intellectual property. Depending on the quality of the fund managers, investors may not always be informed of the planned strategies and changes to them or a change of portfolio manager. Offshore funds are also not subject to any disclosure requirements.

Hedge funds can use fictional or pro forma performance data that are not based on actually completed transactions and should therefore be treated with caution.

To link the investors' interests more closely to those of the manager, it is also customary for managers of such funds to receive performance-related bonuses and be invested in their own funds.

**CAUTION: 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.**

**In unfavourable market situations there is a risk of extremely negative performance, up to and including total loss.**

## Investment techniques

The investment techniques employed by hedge funds include the extensive use of short-selling, leverage, swaps, arbitrage (exploiting price or interest rate differences between markets), derivatives and algorithmic (automated) trading. The investment strategy may employ derivatives such as futures, options and swaps, which entails greater risks. These financial instruments may be subject to significant price volatility, resulting in a high risk of loss for the fund. The low margins required to build up a position in such instruments mean that high levels of borrowing can be used. Depending on the instrument, a relatively small change in the contract price can lead to a large profit or loss compared with the margin deposited. Such losses may be unforeseeable, result in further losses and exceed any margin. If a hedge fund sells uncovered options on securities, it may be exposing itself to an unlimited risk of loss.

## Liquidity and fees

The acquisition of units in hedge funds is complex and not standardised. The minimum investments required are often high and subscriptions can normally be made only once a month, quarter or year, and the required documentation must be completed correctly. The amount subscribed must normally be transferred several days or weeks before the subscription deadline, which entails an additional counterparty risk.

Offshore and hedge funds have limited liquidity. Their investment techniques often involve investments in illiquid financial instruments or instruments with limited scope for transfer. The payment and redemption options are often limited, for example to only once a month, quarter or year, and may require long notice periods. Failure to comply will incur large fees. There are often also lengthy lock-up periods during which investors are required to leave their capital in the fund. Some hedge funds reserve the right to retain part of the proceeds for a specific period if an investor redeems their entire investment, mostly until the next ordinary audit.

Hedge funds are not normally admitted to trading on an exchange and the scope for selling on the secondary market is very limited or non-existent. It may be impossible to unwind an existing position or determine the value or risk of a position.

**CAUTION: Investment vehicles that are not listed on an exchange also involve further risks as there is neither an exchange 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.**

## Subscription, sale and redemption

A hedge fund's articles of incorporation often give its governing bodies extensive freedom. For example, they are not obliged to calculate the net asset value (NAV, see Glossary) at all times. A hedge fund's NAV is not normally known when an investor invests in it or redeems their investment. The NAV is not generally published until the first official subscription or sale date, depending on the strategy. The fund managers are also often allowed to suspend redemptions at their discretion. This is normally in the interests of the existing investors, ensuring that all are treated equally. Hedge funds may be allowed to compulsorily redeem all or part of an investment at any time, with little notice and without giving reasons.

It may also be difficult or impossible to transfer the investment to a financial service provider, especially when the beneficial owner of the investment is no longer the same. Moreover, offshore funds often do not provide for interim distributions, for example of share dividends.

## Side pockets

Within the portfolio of an investment fund, side pockets are a way of separating illiquid investments (primarily private equity or real estate) from liquid ones. As a general rule, only investors who were initial subscribers for the units of a given fund (or who are holders of the fund at the time when an investment in the portfolio is separated) will make a profit or incur a loss from this illiquid investment when it is sold or when some event affecting its liquidity occurs (e.g. an IPO).

### How investors' rights of repayment are affected by side pockets

Investors may continue to exercise their redemption right in respect of the liquid portion of their investment in a fund.

However, that right may not be exercised for any portion of their investment which is segregated in a side pocket.

The portion placed in a side pocket will therefore remain invested either until it is sold or until some event affecting its liquidity occurs. At that point, an investor exercising his redemption right can receive the net amount less performance and management fees and any other charges applicable.

### **The disadvantages of side pockets**

When an investor exercises their redemption right, they will not be redeemed for the entire investment; the liquid part of the investment will be repaid in cash, and the rest will remain invested in side pockets which may take several years to be sold. Investors may therefore be unable to realise their investment in full for an indefinite period, and consequently the value of that investment could fall (or rise) over that period.

Furthermore, there is no guarantee that an investment segregated in a side pocket can be disposed of by the fund at its published value when an event affecting its liquidity occurs or where it may have to be realised urgently. Side pockets are not normally transferable.

Investors should also bear in mind that the creation of a side pocket may occur between the time a redemption request is made and the repayment date.

### **Gates**

These are redemption limits expressed as the maximum percentage of units in a mutual fund which can be redeemed on each liquidity date (normally 20/25% for funds with annual liquidity and 10% for those with more frequent liquidity). These limits are intended to protect unit holders remaining in the fund in the event of massive withdrawals from the fund by other investors; they also enable managers to increase exposure to illiquid assets without the fear of liquidity problems when approaching a date on which sale orders are permitted.

### **How an investor's redemption right is affected by gates**

We can illustrate this by taking the example of a fund with the following characteristics: 30 days' notice, monthly liquidity, exit gate of 10%. An investor places their sale order on 3 January 2021; the order is accepted on 3 January 2021 for 30 days hence, i.e. for 2 February 2021. As the fund's liquidity is monthly, the investor sells their units at the net asset value at the end of February. If sale orders for the same period exceed 10% of the units of the fund, redemptions will be reduced pro rata for each investor wishing to sell, based on the number of units for which each investor has submitted a redemption request.

All units not redeemed during that month owing to application of the 10% limit will have priority the following month, up to the 10% limit, over units for which sale orders are placed in that month.

### **The disadvantages of gates**

If the limit on redemptions is applied, an investor naturally retains their investment in the fund in respect of those units not redeemed, and continues to be exposed to the investment risk. In the period between the date of the sale order and the date on which the investor receives the proceeds of their investment (which can be very long if successive gates are applied) performance can be poor.

### **Lock-ups in mutual funds**

A lock-up is a period in which the funds invested are frozen and are unavailable to the investor. In alternative investments where this condition applies, the lock-up period is normally one year.

### **How redemption rights are affected by lock-ups**

In the case of a "hard lock-up" the investor cannot seek redemption during the lock-up period. If it is a "soft lock-up", they can apply for redemption during the lock-up period but will have to pay a redemption penalty.

### **The disadvantages of lock-ups**

An investor subject to a lock-up naturally has to remain invested for the lock-up period and therefore continues to be exposed to the investment risk, with no possibility of disposing of their investment during that period (except in the case of a "soft lock-up" when they can sell on payment of a penalty).

### 4.3.10.2 Private equity

#### What it is

Private equity is a form of risk capital financing for companies that either are not exchange-listed 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.

Private equity involves investments in young companies (start-ups) and companies with growth potential that are still at an early stage of their development. This category is often termed venture capital.

Private equity is also used to fund the growth or expansion of an existing company. This is known as late-stage or mezzanine financing.

Private equity also comes into play when a company is about to go public or be sold. This type of financing aims primarily to refund the existing owners' original investment with a premium (multiple) from the proceeds of the initial public offering (IPO) or sale. Changes of ownership, for example when a company is delisted or sold to a strategic investor, generally involve some kind of buy-out: a management buy-out (MBO), management buy-in (MBI) or leveraged buy-out (LBO).

The primary goal of private equity is to invest in a company for a limited period and then sell the investment at a profit.

The success of a private equity investment depends not only on the correct timing of the "exit" or sale but also – and especially with indirect investments via a fund, for example – on the quality of the private equity manager, and on the financing strategy the management has implemented.

The exit can be effected through an initial public offering (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. The performance of the equity and bond markets, as well as other specific private equity factors, will determine how easy or difficult the exit phase is and whether the proceeds meet expectations.

#### Risks associated with private equity investments

Private equity investments are regulated less strictly than 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).

Normally, private equity investments cannot be sold until some years after the original investment. There may be no provision for any interim distributions, or at least not until after a few years. In this case, the only prospect of a return is the capital gain that can be realised when the investment reaches the end of its term.

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.

In some cases it may be difficult to transfer the investment to another bank.

**CAUTION:** 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.

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.

**CAUTION:** With private equity you normally undertake in advance to invest a fixed amount (capital commitment) that may be immediately and irrevocably blocked at the Bank. You may lose the ability to dispose of the capital as you see fit, even if the private equity vehicle does not require actual transfer of the full sum or part of it until later. You are exposed to what is known as a capital call.

**CAUTION:** In other cases, you must simply ensure that sufficient liquidity is available when a capital call is made. It is not unusual for further calls for capital to be made at short notice after the initial investment. If you fail to meet the call within a defined period, you may be subject to sanctions set out in the limited partnership agreement that may entail the loss of part or all of the investment.



**CAUTION:** Certain private equity vehicles provide for mechanisms whereby investors may, under certain circumstances, be required to repay distributions already made at a later date. This is known as a clawback or recallable distribution.

**CAUTION:** In exceptional cases, investors may be asked to increase their stake. Investors supplying new capital may increase their prospects of making a profit, but also increase the risk to which they are exposed by the same degree, which may include the loss of their entire investment.

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

With indirect private equity investments, for example in private equity funds, there is no guarantee that the manager will be able to make investments and generate profits that fulfil the investors' expectations; the manager's skills are therefore decisive. In general, the managers of such funds receive performance-related bonuses or remuneration and are often invested in the fund themselves, giving them what is known as "skin in the game". The risks of an indirect investment are essentially the same as those of a direct investment, particularly as regards the capital call mechanism and limited liquidity.

### **4.3.10.3 Private debt**

#### **What it is**

The simplest definition of private debt is a loan from one party to another, under which the borrower pays interest to the lender and undertakes to repay the principal borrowed when the loan matures. In practice, every time a privately owned company borrows money or issues bonds that are not listed on a stock exchange, those borrowings can be classified as private debt.

The two main characteristics of private debt are as follows:

- it is not listed, which results in a degree of illiquidity, and
- its details are confidential

Companies, particularly small and medium-sized ones looking for additional funding, use private debt as a supplement or alternative to traditional bank financing. The benefit for companies is that private debt can be tailored to their needs and broadens their range of funding sources (sometimes over a longer period), along with the possibility of avoiding repayments of principal during the loan term in return for higher interest rates in some cases.

#### **The various types of private debt**

There are various types of private debt. Money may be lent by natural persons or privately owned companies on a case-by-case basis, or through a more formal structure such as a fund.

There are various segments of the private debt market in which to invest:

- medium-term, long-term and very-long-term infrastructure projects
- real estate or real-estate development projects
- direct lending
- loans to borrowers in difficulty ("distressed debt")
- mezzanine financing, where repayment is subordinated to the repayment of "senior" debt, resulting in a higher level of risk
- private debt funds
- shipping and aviation finance
- funding of LBOs (leveraged buy-outs), where one company borrows money to acquire another and the loan is secured against the assets of both the acquired company and the buyer
- single-tranche debt, which is a form of senior debt that combines various tranches of funding into a single instrument.

### Reasons behind the increasing demand for private debt

Zero-interest-rate policies have kept bond yields very low, leading to limited returns. On the one hand, investors seeking superior returns are looking for alternatives to bonds issued by governments in developed countries. On the other, those seeking funding have seen banks adopt tough lending terms. As a result, private debt has increased its share of the lending market. However, this type of investment should be reserved for investors who have a good understanding of the financial markets and sophisticated transactions, who do not have any short-, medium- or even long-term liquidity needs, and who can afford to lose all of their investment.

### Risks associated with private debt investments

Investments will be affected by credit risk, liquidity risk, interest-rate risk and inflation risk. The main risks relate to the solvency of borrowers, along with the legal and financial value of the security provided. In addition, the repayment obligation may be subordinated to the borrower's other, higher-ranking obligations. It is also possible that not all investors will be treated in the same way. Because private debt is not traded on organised markets, it is unlikely that an investor will be able to liquidate these investments before their maturity. Although it may in theory be possible to sell a claim to another investor, the selling price may be lower than the theoretical value of the claim. The absence of a market may also give rise to uncertainties about the investment's value.

Direct investments in real estate, for example, may be subject to risks related to the geographical location of the property or the sector in which the property is used.

The analysis of private debt securities and the formation of contracts, which depend on the legal system of the country or countries concerned, may be more complex than with investments in traditional bonds. This is why it is important to use professionals or funds specialising in this area. Otherwise, the due diligence carried out by investment vehicles in the target companies or their strategies may be insufficient or non-exhaustive, and the Bank is not able to verify this. Since these investment vehicles are often not subject to regulatory supervision, this may result in a high risk of default or fraud.

Private debt funds may lack diversification across sectors and jurisdictions, and leverage may exist if the investment vehicle also borrows money.

Private debt funds are closed-end, illiquid funds with long investment terms (up to 7 years or even more), relatively high management and performance fees and complex structures, and investors will also have to pay the Bank's custody fees, investment strategy fees and other fees.

Investors in a private debt fund must make a capital commitment, which the fund manager will call upon by making "capital calls" depending on the fund's investment needs. This capital commitment will remain tied up for a certain period, which may be 5-10 years, during which the investor will be unable to access the money depending on the applicable provisions of the fund's memorandum or prospectus.

Depending on the jurisdiction in question, an investor may have to return distributions made by a fund under clawback or recallable distribution provisions.

### 4.3.10.4 Real estate

#### How you can 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.

#### 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.

## 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). These enable investors to invest in real estate without incurring certain disadvantages, such as illiquidity.

### Risks associated with real estate investments

Real estate investments are based on physical assets – land and buildings – that are ultimately unique, and 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, the high capital outlay required and the illiquidity of the property market makes diversification difficult or even impossible.

Property markets are also frequently lacking in transparency, and require precise knowledge of local circumstances. It is therefore vital to involve local experts, which hampers access to the market.

Anyone investing indirectly in real estate must consider the risks attached to the financial instrument in question. There are traditional, strictly regulated funds that invest in real estate, but indirect real estate investments can also have similar characteristics to hedge funds or private equity and thus entail higher risks. Ultimately, physical assets – buildings and land – underlie all real estate investments.

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.

## 4.3.10.5 Precious metals and other commodities

### Precious metals

The most common precious metals are gold, silver, platinum and palladium. It is possible to invest in them either directly – by buying the physical metal or opening a precious metals account – or indirectly – by buying fund units, derivatives or structured products linked to the price of a precious metal.

When investing directly in physical metals, investors can choose from different units of weight and levels of purity. Gold is normally present on European markets in the form of non-exchangeable, numbered bars (or ingots) weighing 12.5 kg each with a purity of 99.5–99.99% and exchangeable bars weighing 250 g, 500 g or 1 kg with 99.99% purity. Coins such as the South African Krugerrand and the Canadian Gold Maple Leaf are another means of investing in precious metals.

On European markets, silver is normally traded in the form of numbered bars or ingots weighing around 30 kg or 1 kg, while platinum is traded as 1 kg or one-ounce bars and palladium as 1 kg bars.

Investors who buy a physical metal acquire ownership rights. In the case of non-exchangeable bars, they own individual, numbered units. In the case of exchangeable (fungible) assets, they own the weight of metal in the specified form, e.g. 1 kg bars or a specific number of coins.

### Risks associated with precious metals investments

When investors deposit physical precious metals with a bank, they are stored either by the bank itself or by a custodian on behalf of the bank. Should the bank be liquidated, Swiss law prevents investors' physical metal holdings from being included in the bankruptcy assets. The same applies in most comparable jurisdictions.

If, on the other hand, an investor opts to open a precious metals account with a bank, the investor does not have ownership rights but merely a claim to delivery of the physical metal. This means that the investor is exposed to the risk of default by the bank, for example if it goes bankrupt.

Precious metal prices can fluctuate considerably, particularly due to macroeconomic and market trends. Precious metals, especially gold, are sometimes regarded as "safe haven" investments during periods of financial market turmoil. Other factors that can influence precious metal prices include production costs, demand from non-financial sectors such as industry and the jewellery trade, monetary policy and central banks' reserves.

## 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.

A common way for private individuals to invest indirectly in commodities is via structured products. Other ways to invest in commodities are commodity funds and financial instruments that are not admitted to trading on an exchange such as over-the-counter swaps and options. These are traded directly between the parties concerned and are tailor-made financial instruments. See the section on how forwards and futures work for more details.

**CAUTION: With commodity futures, investors may receive physical delivery of the commodity concerned on expiry under certain circumstances, whereas structured products normally provide for cash payment. Investors who prefer cash settlement must sell their futures before the expiry date. Commodity investments are therefore more risky than, for instance, equities or collective investments.**

### Risks associated with 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, for example on oil, base and precious metals, are normally easy to trade, regardless of their term.

**CAUTION: Futures can become illiquid if market activity is low. This can cause their prices to fluctuate significantly, which is a typical feature of commodities.**

#### 4.3.11 Cryptocurrencies and tokens

##### What they are

In an initial coin offering (ICO), investors transfer financial assets to the ICO organiser, usually in the form of cryptocurrencies. In return, they receive block-chain-based “coins” or “tokens”. These are created and stored in a distributed system using a specially developed blockchain or smart contracts (see Glossary) on an existing blockchain (see FINMA guidance). The tokens issued can have different functions. They can serve as a simple means of payment (cryptocurrency) or confer the right to use a service or a right of ownership in relation to the ICO organiser.

Cryptocurrencies are a digital means of making cashless payments independently of third parties such as banks. Transactions in cryptocurrencies are handled and recorded on a distributed and cryptographically secured blockchain.

In Switzerland, tokens that confer ownership rights are subject to the applicable laws, including the Anti-Money Laundering Act (AMLA) and the Financial Market Infrastructure Act (FMIA).

##### Risks associated with investments in cryptocurrencies and tokens

The specific risks associated with investments in cryptocurrencies and tokens include high volatility due to their still low market capitalisation, speculation and a continually changing legal framework in various countries. Tokens often involve investing in a start-up, which brings a high risk of default. Investments in ICOs are also subject to the risk of fraud, for example due to the absence or inadequacy of direct regulation.

Cryptocurrency holdings can only be accessed using a digital key and are thus blocked if the key is lost.

Investors who are interested in this type of investment opportunity are advised to study technical and regulatory developments in the field carefully and in particular to consult the relevant publications, including those issued by FINMA.

## GLOSSARY

Actively managed fund	Type of investment fund in which the fund manager tries to generate added value through targeted security selection, see section 4.3.4.
Algorithmic trading	Automatic issuing of buy and sell orders controlled by computer programs, see section 4.3.10.1.
Alternative (non-traditional) investment	An instrument that has little or no correlation with the conventional financial markets, such as equities and bonds. Examples include hedge funds, private equity and commodities, see section 4.3.10.1.
American-style option	A type of option that can normally be exercised on any trading day up to the expiry date, see section 4.3.5.
Arbitrage	A type of exchange transaction that aims to make a profit by exploiting price or interest rate differences between various markets, see section 4.3.10.1.
Asset allocation fund	A fund that invests in a range of different asset classes, e.g. shares, bonds and real estate. Such funds enable standardised asset management and, especially for investors investing small or medium-sized sums, permit risk diversification to match their risk profile, see section 3.2.1.
Asset-backed security (ABS)	Credit derivative backed (secured) by a portfolio or pool of assets, see section 4.3.9.
At the money	Term used when the current market value of an option's underlying asset is the same as the strike price, see section 4.3.5.
Blockchain	A type of distributed ledger or shared database; in the case of bitcoin, it records payments between members of the network in a chain of blocks, see section 4.3.11.
Bond	From the issuer's perspective, a bond is a kind of fixed-term loan. The issuer (borrower) normally pays a fixed rate of interest (coupon) at regular intervals, see section 4.3.2.
Bond fund	A collective investment scheme that invests mainly in bonds with or without fixed coupons, convertible bonds and warrant bonds as well as variable-interest bonds, see section 4.3.4.
Book-entry security	A security, such as a share, bond or collective investment scheme, that is not kept in physical form but is simply booked to a securities account, see section 3.4.
Broker	A dealer or intermediary in securities, insurance policies and other financial services, see section 4.2.1.
Call option	A type of option that confers the right, but not the obligation, to purchase a specified quantity of a specific underlying asset at a precisely stipulated price (strike price) either at a specific point in time (European-style option) or during a specified period (American-style option), see section 4.3.5.
Cap	The maximum repayment on a structured product, see section 4.3.8.
Certificate	A structured product in the form of a debt security allowing investors to participate in the performance of specific securities or other financial instruments, see section 4.3.8.
Clearing / clearing house	The settlement or netting of financial instrument transactions by securities dealers; carried out by a clearing house (see section 3.2.) such as, in Switzerland, SIX SIS Ltd.
Closing out	A term that originated in derivatives and futures trading, closing out refers to closing an open position by executing a corresponding opposite transaction, so that the two cancel each other out.
CoCo bond	Contingent convertible, see section 4.3.2.
Collateralised debt obligation (CDO)	A sub-category of asset-backed securities, see section 4.3.9. CDOs are backed by a debt portfolio.
Collective custody	An arrangement whereby a number of investors' financial instruments are held collectively by a third-party custodian, i.e. they are not held separately for each individual investor, see section 4.3.4.
Collective investment scheme	A pool of assets supplied by investors to be jointly invested on their account. Collective investment schemes make broadly diversified investments possible with a small capital outlay, see section 2.4.
Commodity	A physical good, mostly in the form of a natural raw material, that is standardised when used as the underlying for a transaction. Commodity investments can be either direct or indirect, see section 4.3.10.5.
Contract price	Contractually agreed price of an investment such as a hedge fund, see section 4.3.10.

<b>Convertible bond</b>	A bond that gives the holder the right to convert it within a predefined period and at a predefined ratio into an equity instrument from the same issuer, e.g. a share, see section 4.3.2.
<b>Correlation</b>	A concept from statistics, correlation measures the relationship between two series of figures. In the world of finance, it measures the degree to which two investments move relative to each other.
<b>Counterparty</b>	The other party in a contractual arrangement.
<b>Covered option</b>	A transaction in which an investor purchases an underlying asset – a share, bond or currency – and simultaneously writes (sells) a call option on the same asset, see section 3.3.4.
<b>Credit and catastrophe derivatives</b>	Financial instruments used for financing or risk transfer purposes where the underlying is an event, such as a credit event or a natural disaster, see section 4.3.9.
<b>Credit-linked note (CLN)</b>	Structured product in the form of a bond where repayments and interest depend on the performance of a specific underlying or reference portfolio, see section 4.3.9.
<b>Credit risk</b>	The risk of loss if a party to a transaction becomes insolvent. With debt instruments such as bonds, this risk is known as the issuer risk because the borrower normally acts as the issuer, see section 4.1.2.
<b>Cryptocurrency</b>	A means of digital payment based on a distributed database known as a blockchain, see section 4.3.11.
<b>Currency risk</b>	Risk of exchange-rate fluctuations if the reference currency is not the currency of the financial instrument, see section 4.1.3.
<b>Custody chain</b>	Custody of financial instruments is routinely handled by a number of parties making up what is known as the custody chain, see section 4.2.1.
<b>Debt instrument</b>	Any kind of security that is not an equity security, e.g. a bond.
<b>Derivative</b>	A financial contract where the price is derived either from assets such as equities, bonds, commodities or precious metals or from variables such as exchange rates, interest rates and indices, see section 3.3.
<b>Direct investment</b>	An investment that involves directly acquiring the asset concerned rather than a financial instrument based on it, see section 3.8.
<b>Discount</b>	A reduction granted on, for example, an issue price, see section 3.4.2.
<b>Emerging market</b>	A country that has not yet acquired all the features of a fully developed market, see section 4.1.2.
<b>European-style option</b>	A type of option that can only be exercised on a specific expiry date, see section 4.3.5.
<b>Exchange trading</b>	Trading, in particular in financial instruments (certificated and uncertificated / book-entry securities), on an organised, regulated market referred to as a secondary market, as distinct from issuance, which constitutes the primary market, see also “Issue / issuance”.
<b>Expiry date</b>	In an option transaction, the date on (or until) which the agreement between the buyer and seller confers the right to buy or sell a specific underlying asset at a predefined price, see sections 4.3.5, 4.3.6 and 4.3.7.
<b>Financial instrument</b>	Term for any kind of certificated or uncertificated security or derivative, including those that are not standardised and suitable for mass trading; see also the definition in the new Financial Services Act (FinSA), see section 3.2.1.
<b>Financial intermediary</b>	A natural person or legal entity that, in return for payment, accepts assets from third parties and holds them in custody or assists in investing or transferring them.
<b>Financial service provider</b>	A person or entity that provides financial services in Switzerland or to clients in Switzerland on a professional basis, professional being defined as involving an independent economic activity conducted on an ongoing basis for profit, see sections 3.6 and 4.2.3.
<b>Financing level</b>	In a mini-future, the financing level determines the level of debt financing and therefore the mini-future’s value, see section 4.3.8.
<b>Fixed-income investment</b>	A type of investment that has a specific term and pays interest on specific dates, see sections 4.3.3 and 4.3.4. Examples include bonds and money market investments.
<b>Forward</b>	A customised contract for the purchase or sale of an asset at a future date. Forwards are not traded on an exchange, see section 4.3.2.
<b>Forward / future</b>	An agreement whereby a buyer and a seller undertake to buy and sell a specific underlying at a predefined price at a specific date in the future (the expiry date), see section 4.3.2.
<b>Fund of funds</b>	An investment fund that invests in a number of other funds, see section 4.3.4.

Future	A standardised contract for the purchase or sale of an asset at a future date. Futures are traded on an exchange, see section 4.3.7.
Guarantor risk	Risk of the guarantor of a structured product becoming insolvent, see section 4.3.8.
Hard currency reserves	Reserves in hard or stable currencies with exchange rates that are stable or rising against other currencies in the medium and long term.
Hedge fund	A type of collective investment scheme that is subject to limited or no regulation and supervision. Hedge funds often adopt aggressive strategies and use investment techniques that decouple investment performance from the performance of the underlying markets, see section 4.3.10 and section 4.3.10.1.
Hybrid bond	A type of debt instrument that contains equity-like elements, see section 4.3.2.
Hybrid financial instrument	Type of financial instrument, such as a convertible bond, that combines the features of various investment instruments that are often exchanged for each other. It may have characteristics of both equity and debt.
In the money	A call option is in the money if the current market value of the underlying is above the strike price. A put option is in the money if the current market value of the underlying is below the strike price, see section 4.3.5.
Indirect investment	An indirect investment involves acquiring an interest in the underlying asset via an investment vehicle, see section 3.8.
Ingot	A bar or block of a precious metal, see section 4.3.10.5.
Initial coin offering (ICO)	In an initial coin offering, investors transfer financial assets to the ICO organiser, usually in the form of cryptocurrencies. In return, they receive blockchain-based "coins" or "tokens", see section 2.15.
Initial margin	The sum of money required to be deposited as security / collateral when concluding a forward contract involving short selling, see section 3.5.
Initial public offering (IPO)	First-time offering of shares in a company to the public (see section 4.3.10.2): when a private company whose shares had previously been held by a restricted group of persons is transformed into a public company by issuing shares to the public and listing them on an exchange; not to be confused with an "issue".
Investment	An allocation of money with a view to obtaining a financial benefit (return).
Issue / issuance	The creation and first-time issuing of financial instruments on the primary market (as distinct from an initial public offering), see section 3.5.
Issuer	Entity that offers or intends to offer securities for sale, see section 3.5.
Issuer risk	Risk of the issuer of the financial instrument becoming insolvent, see section 4.1.1.
Key Information Document (KID)	Publication issued by a financial service provider designed to explain the risks and costs of a financial instrument to retail clients in terms that are easy to understand; required under the federal Financial Services Act (FinSA), see section 2.1.
Leverage	Disproportionate participation in changes in the price of an underlying, involving greater risks for the investor, see section 4.1.12.
Liquidity risk	The risk that an investor will not always be able to sell an investment at an appropriate price, see sections 4.1.9, 4.1.12 and 4.3.4.
Lombard loan	Loan granted in exchange for pledging a set percentage of the ownership rights to liquid assets such as equities, bonds or investment funds.
Margin call	Limited or unlimited obligation, imposed by the law or a contract, to deposit further collateral over and above those already made under certain circumstances.
Market risk	The risk of price fluctuations within a given period due to factors impacting a specific market. Volatility is the generally accepted measure of market risk, see section 4.3.2.
Minimum repayment	If the level of capital protection offered by a structured product is less than 90%, it is normally referred to as a minimum repayment product rather than a capital protection product. Used in connection with yield enhancement and participation products, see section 4.3.8.
Money market fund	A type of fund that invests in short-term, fixed-income investments and is suitable for short-term investment purposes, see section 4.3.4.
Mortgage-backed security (MBS)	A credit derivative in which the security is backed by a portfolio of mortgages, see section 4.3.9.
Multi-manager fund	Type of fund that spreads its investments among a number of fund managers covering different investment styles, markets and financial instruments, see section 4.3.4.



<b>Net asset value (NAV)</b>	The total value of a fund's assets minus its liabilities, measured as the price of a fund unit or share on a given date, see sections 4.3.4 and 4.3.10.1.
<b>Nominal value</b>	The value stated on the face of a security.
<b>Offshore fund</b>	A collective investment scheme domiciled in a country with relatively relaxed regulatory and tax legislation; examples include the Cayman Islands and the British Virgin Islands, see section 4.3.10.
<b>Open-ended collective investment scheme</b>	A contractual investment fund in which investors are normally allowed to redeem their units at any time and new investors can join at any time, see section 4.3.4.
<b>Option</b>	An agreement between a buyer and a seller conferring the right to buy or sell a specific underlying asset (often referred to simply as the "underlying") at a predefined price at or before a specific point in time (the expiry date), see section 4.3.5.
<b>OTC derivative</b>	A derivative that is traded over the counter (OTC) rather than on an exchange, see section 4.2.1.
<b>OTC option</b>	A type of option that is neither securitised nor traded on-exchange. Such options are contracted directly off-exchange between the seller and the buyer, see section 4.3.5.
<b>Out of the money</b>	A call option is out of the money if the current market value of the underlying is below the strike price. A put option is out of the money if the current market value of the underlying is above the strike price, see section 4.3.5.
<b>Participation component</b>	In a structured product, the component that determines the extent to which an investor can profit from the performance of the underlying(s), see section 4.3.8.
<b>Passively managed investment fund</b>	Type of investment fund, also called an index fund, that tracks a market index. It is a simple and inexpensive way of achieving broad diversification, see section 4.3.5.
<b>Path-dependent option</b>	A type of option that requires the investor to consider not just the market value of the underlying at the time the option expires or is exercised but also fluctuations in the price of the underlying during the life of the option, see section 4.3.5.
<b>Physical delivery</b>	In addition to cash payment, financial instruments can provide for delivery of, for example, the physical asset underlying an option, with the associated settlement risk, see section 4.3.5.
<b>Plain vanilla option</b>	A conventional call or put option without additional features, see section 4.3.5.
<b>Private equity</b>	A form of investment to provide risk capital financing for companies that either are not listed on a stock exchange or (in exceptional cases) wish to delist, see section 4.3.10.2.
<b>Publication requirement</b>	The Collective Investment Schemes Act imposes wide-ranging publication requirements on contractual investment funds, with regard to the issue and redemption price and net asset value.
<b>Put option</b>	A type of option that gives the buyer the right, but not the obligation, to sell a specific quantity of an underlying asset at a predefined strike price during or at the end of the option's term, see section 4.3.5.
<b>Ratio</b>	In the context of options, the ratio of the underlying to a single option, see section 4.3.5.
<b>Real estate fund</b>	Collective, indirect investment in real estate, see section 4.3.4 and section 4.3.10.4; see also "Real estate investment trust (REIT)"
<b>Reference currency</b>	Currency in which an investment portfolio or custody account is administered and settled.
<b>Reference entity</b>	Structured products with a reference entity have a basic structure that, in addition to a conventional capital protection, yield enhancement or participation product, includes an additional reference (e.g. corporate or government) bond, see section 4.3.8.
<b>Risk premium</b>	The difference between the returns on a risky and a risk-free investment, see section 4.3.4.
<b>Secondary market</b>	The market on which investors buy and sell (previously issued) financial instruments they already own, see section 4.3.1.
<b>Securities dealer</b>	Natural person, legal entity or partnership that, on a professional basis, either offers financial instruments (see "Security") publicly on the primary market or trades them on the secondary market or that creates and publicly offers derivatives (see "Derivative").
<b>Security</b>	Standardised, certificated or uncertificated security, derivative or book-entry security suitable for mass trading, see section 3.2.
<b>Segregation</b>	In the event that a bank or securities dealer acting as custodian goes bankrupt, the owners of custody account assets (e.g. movable objects and securities) are entitled to have those assets segregated from other assets (see Art. 37d BA, Art. 17 FISA). This has the effect of excluding the assets from the bank or securities dealer's bankruptcy assets and ensuring they remain with the account holder, see section 4.3.4.

<b>Settlement</b>	Performance of an obligation, for example to deliver a financial instrument on the expiry date, see also “Settlement risk”.
<b>Settlement risk</b>	Risk of having to buy a financial instrument at a specific price before delivery or of having to deliver it without receiving the purchase price, see section 4.3.10.1.
<b>Share</b>	Equity security embodying ownership of a share in the equity of a public limited company, see section 4.3.1.
<b>Short / long position</b>	Terms used in the financial world to refer to selling and buying positions, respectively, see section 4.3.10.1. In general, a “long” position is one in which the investor expects the price of a financial instrument such as a share or derivative to rise, while a “short” position – effected for example by short selling – is one where the expectation is that it will fall.
<b>Short sale</b>	The forward sale of an underlying the seller does not hold at the time the contract is signed. It entails a risk in that the seller may have to buy the underlying at a price higher than the agreed price in order to meet the delivery obligation on expiry. Some exchanges no longer allow short sales, see section 4.3.7 and section 4.3.10.1.
<b>SICAF</b>	Collective investment scheme in the form of an investment company with fixed capital, see section 4.3.4.
<b>SICAV</b>	Collective investment scheme in the form of an investment company with variable capital, see section 4.3.4.
<b>Smart contract</b>	Type of contract that can be concluded via a blockchain, with all stages of settlement and implementation being automated and no institution or intermediary having to oversee or intervene in the process, see section 4.3.11.
<b>Strike (price)</b>	The price at which the buyer of an option has the right to purchase (call) or sell (put) the underlying assets, see section 4.3.5.
<b>Structured product</b>	A financial instrument based on one or more underlying assets and, often, a derivative component as well, see section 4.3.8.
<b>Swap</b>	A contract for the exchange of payment streams; not traded on an exchange or via mass trading, see section 4.3.6.
<b>Third bankruptcy class</b>	The lowest-ranked bankruptcy class, comprising non-privileged claims, see section 4.3.2.
<b>Time value of an option</b>	The time value of an option is determined by a variety of factors, including its remaining term and the volatility of the underlying. It reflects the chance that the option will be in the money, see section 4.3.5.
<b>Token</b>	Blockchain-based currency unit, also known as a coin, see section 4.3.11.
<b>Trade repository</b>	A database providing for the centralised electronic recording of derivative transaction data, see section 4.2.1.
<b>Uncertificated security</b>	Synonym of ‘book-entry security’. A financial instrument that only exists as an entry in a custody account and does not exist in physical form, see section 3.4.
<b>Underlying</b>	The asset (e.g. share, bond, index, currency or commodity) on which a derivative (e.g. option, warrant or future) is based, see section 3.3.
<b>Variation margin</b>	When short selling on a futures contract, the investor is required to deposit an initial margin when the contract is concluded. The variation margin is an additional figure calculated periodically during the life of the contract; see also “Margin call” and section 4.3.7.
<b>Venture capital</b>	An asset class in private equity involving investments in young companies (start-ups) and companies with growth potential that are still in an early stage of their development, see section 4.3.10.2.
<b>Volatility</b>	The extent of the price fluctuations of financial instruments during a specific period. Volatility is a measure of market risk, see section 4.1.9.
<b>Warrant</b>	An option in securitised form that is traded on an exchange or over the counter, and in which the issuer can set the specifications, see section 4.3.5.



