

## General description of the nature and risk of financial instruments

The purpose of this document is to provide clients or potential client with a general description of the nature and risks of financial instruments pursuant to our obligations under the Markets in Financial Instruments Directive (Directive 2014/65/EU) ("**MIFID II**").

### Risk Disclosure Notice

This statement does not purport to disclose all the risks or the other relevant considerations of entering into transactions. You should refrain from entering into any such transactions unless you fully understand all such risks and have independently determined that the transactions are appropriate for you.

Before deciding to transact in any financial products and investments, you will need to have assessed the risks inherent in those financial instruments, structured deposits, commodities or other financial products and in any related services and strategies.

As in any financial transaction, you should ensure that you understand the requirements (including investment restrictions), applicable to you established by your regulators or by your board of directors or other governing body. You should also consider the legal, tax and accounting implications of entering into any transaction.

You should not enter into transactions unless you understand the nature of the transaction and the relevant financial product, and the extent of your exposure to risk and potential loss.

## General description of the main risks associated with transactions in financial products

### *Market Risk*

Market risks are risks that may impact the entire market and relate to the risk that an investor may experience losses due to a change in the value of a financial instrument.

Market risk may materialise due to both macroeconomic factors as well as factors specific to the Financial Instrument. Macroeconomic risks may include interest rate risk, foreign exchange rates risk, commodity risk, equity risk, economic stability, inflation, political factors, regulation and taxes.

Instrument specific market risks may materialise due to supply and demand, factors affecting the issuer of the Financial Instrument and the liquidity and the volatility in the market for that instrument.

### *Liquidity risk*

Insufficient market liquidity may prevent investors from selling their securities at the market price. A lack of liquidity due to market supply and demand arises when a security is exclusively or almost exclusively in supply (seller's price) or exclusively or almost exclusively in demand (buyer's price) at a certain price. A lack of liquidity due to a security's inherent characteristics or due to market practice may occur, for example, because of lengthy transcription procedures for transactions involving registered shares, long execution delays because of market practice or other trading restrictions, or a short-term need for liquidity that cannot be covered through sales of securities.

### *Interest rate risk*

Interest rate risk is the risk associated with a change in market interest rates resulting in a fall in a security's price. For fixed-rate investments, such as bonds, the interest rate risk is the risk that a change in interest rates may result in a change in a bond's price and, therefore, a capital gain or loss. For variable rate investments, such as shares, an increase in interest rates generally has a negative effect on share prices.

### *Insolvency and credit risk*

The insolvency risk of a debtor is the likelihood, in the case of the issuer of a security, that it may no longer be able to service its liabilities (such as paying interest or repaying the initial capital). An issuer's solvency may vary

according to general economic trends or changes regarding the issuer's company and/or business sector throughout the term of the financial instrument. In particular, this could be due to economic changes or changes regarding the company, business sector and/or country concerned, as well as political developments having significant economic consequences. A deterioration of the issuer's solvency will have an adverse effect on the price of the securities concerned.

#### **Currency risk**

Since foreign exchange rates fluctuate, a currency risk exists whenever securities are denominated in a foreign currency. A country's foreign exchange rate is particularly influenced by key factors such as its inflation rate, the gap between domestic and foreign interest rates, its projected economic development, the political situation and the safety of investments in the country.

#### **Inflation risk**

Currency devaluations may cause an investor to incur a financial loss. Therefore, it is important for investors to take into account the real value of their existing assets as well as the real realisable yield on this portfolio. Real interest rates should be used, i.e., the difference between the nominal interest rate and the inflation rate.

#### **Price volatility risk**

Volatility risk is the likelihood that the price of a variable rate investment will be subject to fluctuations, varying in intensity, and resulting in a capital gain or loss.

#### **Change in law risk**

If there is a change in law or regulation which affects an investment, or the manner in which it is traded or held, additional costs might be incurred or, in extreme circumstances, investments lost.

#### **Tax risk**

A change in tax law to impose a new tax on the transfer or holding of an instrument could result in costs being incurred when realising one's investment

#### **Third party risk**

Certain investments may need third parties to act in relation to investments traded or held by you (e.g. custodians, settlement agents, exchanges). Your investments may be at risk in the event of failure and/or fraud in respect of one of these third parties

#### **Fraud risk**

If there is a fraud in relation to investments which you hold, you may be at risk of losing your investment.

### **Product risk disclosures**

#### **Bonds**

Bonds are negotiable debt instruments issued in bearer or registered form by a company, a government body or other entity to creditors, and whose par value at issuance usually represents a fraction of the total amount of the debt. The duration of the debt as well as the terms and conditions of repayment are determined in advance. Unless stipulated otherwise, the bond is repaid either at the maturity date, or by means of scheduled payments, or at different rates determined by drawing lots. The interest payments on bonds may be either (i) fixed for the entire duration or (ii) variable and often linked to reference rates (e.g. FIBOR or LIBOR). The purchaser of a bond (the creditor) has a claim against the issuer (the debtor).

Investments in bonds may involve risks including, but not limited to, the following:

**Insolvency risk:** the issuer may become temporarily or permanently insolvent, resulting in its incapacity to repay the interest or redeem the bond. The solvency of an issuer may change due to one or more of a range of factors including the issuing entity, the issuer's economic sector and/or the political and economic status of the countries concerned. The deterioration of the issuer's solvency will influence the price of the securities that it issues.

**Interest rate risk:** uncertainty concerning interest rate movements means that purchasers of fixed-rate securities carry the risk of a fall in the prices of the securities if interest rates rise. The longer the duration of the loan and the lower the interest rate, the higher a bond's sensitivity to a rise in the market rates.

**Credit risk:** the value of a bond will fall in the event of a default or reduced credit rating of the issuer. Generally, the higher the relative rate of interest (that is, relative to the interest rate on a risk-free security of similar maturity and interest rate structure –usually a government bond or certificate of deposit, generally considered to be free from risk of monetary loss), the higher the perceived credit risk of the issuer.

**Early redemption risk:** the issuer of a bond may include a provision allowing early redemption of the bond if market interest rates fall. Such early redemption may result in a change to the expected yield.

**Risks specific to bonds redeemable by drawing:** bonds redeemable by drawing have a maturity that is difficult to determine, so unexpected changes in the yield on these bonds may occur.

**Risks specific to certain types of bond:** additional risks may be associated with certain types of bond, for example floating rate notes, reverse floating rate notes, zero coupon bonds, foreign currency bonds, convertible bonds, reverse convertible notes, indexed bonds, and subordinated bonds. For such bonds, you are advised to make inquiries about the risks referred to in the issuance prospectus, and not to purchase such securities before being certain that all risks are fully understood. In the case of subordinated bonds, you are advised to enquire about the ranking of the debenture compared to the issuer's other debentures. Indeed, if the issuer becomes bankrupt, those bonds will only be redeemed after repayment of all higher ranked creditors and, as such, there is a risk that you will not be reimbursed. In the case of reverse convertible notes, there is a risk that you will not be entirely reimbursed, but will receive only an amount equivalent to the underlying securities at maturity.

**Risk relating to market conditions:** the price of a bond and its disinvestment risk may each be affected by factors relating to wider market conditions, both positive and negative, and such market conditions will affect each issuer differently depending on the nature and size of the issuer, amongst other factors; a bond cannot therefore be assessed as an investment in isolation.

**Disinvestment risk:** bonds may be affected by impediments to disinvestment. In respect of non-listed bonds, these are generally speaking less liquid than listed bonds. There may be no market for such bonds, meaning that the bond holder is unable to exit this investment before the maturity date. This exposes the bond holder to inflation and/or interest rate risk, as the return on the bond may become lower than the rate of inflation or interest rates available elsewhere.

**Tax call risk:** the issuer of the bond may have the right to call the bond should there be an adverse change to the tax laws that affect it. This may mean that the yield on the bond is lower than anticipated.

**Termination of listing:** where the bonds are listed or admitted to trading, the relevant issuer will not be obliged to maintain the listing or trading. Bonds may be suspended from trading and/or de-listed at any time in accordance with applicable rules and regulations of the relevant stock exchange(s). This may result in reduced liquidity or a reduction in the value of the bonds.

### ***Convertible and Exchangeable Bonds***

These instruments are bonds, the fixed return of which can be converted into the shares (or a cash payment linked to the value of the shares) of the bond issuer at the option of the bondholder, the issuer, or either of them. In addition to the risk outlined in "Bonds" above, investments in convertible and exchangeable bonds may be exposed to the following risks:

**Derivatives risk:** as these bonds include an embedded equity derivative, investors should consider the effect of the embedded derivative on the value of the bond, which may be to amplify any losses.

**Equity risks:** on exercise of the conversion rights, holders are exposed to the risks relating to shares (as described above) in respect of the relevant equity securities.

**Conversion risk:** conversion of the bond into equities may only be possible during certain periods of time and may also be subject to certain other conditions. This may mean that the holder is unable to exercise its conversion right at the most advantageous time, which may result in reduced profits or increased losses.

### ***Asset-backed Securities***

An asset-backed security ("**ABS**") is a debt security in respect of which the income payments, and therefore the value, are derived from and collateralised (or "backed") by a specified underlying asset or pool of underlying assets. The asset can be a loan, a lease, a pool of secured loans or receivables relating to assets such as cars, aircraft or real estate or revenue streams (for example, trade debts or football ticket sales). In addition to the risks outlined in "Bonds" above, the holder of an ABS is exposed to certain risks including, but not limited to, the following:

**Credit risk:** the holder of an ABS is exposed to the credit risk of the issuer of the ABS and the borrower against the underlying asset (for example, the company that has taken out a loan against an aircraft). These two risks may be related. Wide-spread default by underlying obligors may lead to the insolvency of the issuer of the ABS.

**Operational risk:** often, an ABS is issued by a special purpose vehicle (“SPV”) which is specifically formed for the purpose of issuing the ABS and purchasing the relevant asset or assets. An SPV is highly dependent on third parties such as corporate service providers, servicers/asset managers, paying agents, trustees and other service providers to meet its own obligations. It is therefore exposed to the operational and credit risk of those third parties.

**Shortfall:** the right of a holder of an ABS to participate in the assets of the issuer will be limited to the net proceeds of the assets secured for such holder’s benefit. Such proceeds may be insufficient to meet all (or, depending on the transaction or circumstances, any) payments due under such ABS.

**Market risk:** a holder of an ABS is exposed to market risk in respect of the underlying asset. If the market value of the collateral against which the loan has been made falls or liquidity is reduced, the issuer of the ABS may be unable to recover the full amount of the loan it has made to a defaulting borrower.

**Ownership:** the holder of the relevant ABS does not have any ownership rights over the underlying assets and will therefore have no claim over the underlying obligor(s) in the event of its or their insolvency.

**Performance of manager:** the performance of the manager of the SPV may also affect the value of the ABS. If the SPV (or originator or portfolio manager) has incorrectly assessed the risk profile of the securitised assets, the rate of default may exceed expectations and increase the risk of losses.

**Early termination:** ABS transactions may be terminated prior to their maturity date (due to regulatory, tax change or other events of default). Early termination may mean an investor’s expected return is not provided and/or not all the investment is returned. The holder of the relevant ABS may not be able to reinvest the proceeds in a product with comparable returns.

### **Shares**

A share is an instrument representing a shareholder’s rights in a company. Shares may be issued in bearer or registered form and may be certificated or non-certificated. One share represents a fraction of a corporation’s share capital. Dividend payments and an increase in the value of the security are both possible, although not guaranteed. The shareholder has financial and ownership rights which are determined by law and the issuing company’s incorporation documents. Unless otherwise provided, transfers of bearer shares do not entail any formalities. However, transfers of registered shares are often subject to limitations.

Dealing in shares may involve risks including, but not limited to, the following:

**Company risk:** a share purchaser does not lend cash to the company, but becomes a co-owner of the corporation. He or she thus participates in its development as well as in chances for profits and losses, which makes it difficult to forecast the precise yield on such an investment. An extreme case would be if the company went bankrupt, thereby wiping out the total sums invested.

**Price risk:** share prices may undergo unforeseeable price fluctuations causing risks of loss. Price increases and decreases in the short-, medium-and long-term alternate without it being possible to determine the duration of those cycles. General market risk must be distinguished from the specific risk attached to the company itself.

**Dividend risk:** the dividend per share mainly depends on the issuing company’s earnings and on its dividend policy. In case of low profits or losses, dividend payments may be reduced or not made at all.

**Risk relating to market conditions:** the price of a share and its disinvestment risk may each be affected by factors relating to wider market conditions, both positive and negative, and such market conditions will affect each company differently depending on the nature and size of the company, amongst other factors; a share cannot therefore be assessed as an investment in isolation.

**Disinvestment risk:** shares may be affected by impediments to disinvestment (e.g. shares may prove illiquid or difficult to sell and/or may be difficult to sell at a price equal to or greater than the transaction price at the point in time that the purchaser wishes to sell).

**Dilution risk:** in the absence of any restrictions in the incorporation documents of the company or other agreement, an issuer may issue more of its shares, thereby potentially reducing the value of the holding and putting downward pressure on the amount of dividends per share.

**Termination of listing:** where the shares are listed or admitted to trading, the relevant issuer will not be obliged to maintain the listing or trading. Shares may be suspended from trading and/or de-listed at any time in accordance with applicable rules and regulations of the relevant stock exchange(s). This may result in reduced liquidity or a reduction in the value of the shares.

### **Money Market Instruments**

A money market instrument is a borrowing of cash for a period, generally no longer than six months, but occasionally up to one year, in which the lender takes a deposit from the money markets in order to lend it to the borrower. The borrower must specify the exact amount and the period for which he wishes to borrow.

Examples of money market instruments include certificates of deposit, treasury bills and commercial paper, or any other instruments with substantially equivalent features that: (i) have a value that can be determined at any time; (ii) are not derivatives; and (iii) have a maturity at issuance of 397 days or less. Like other debt instruments, money market instruments may be exposed to the major risk types, such as credit risk and interest rate risk.

Money market instruments may be exposed to the following risks:

**Market risk:** when the equity and debt markets are extremely volatile, investing in money market instruments is generally considered to be lower risk. Conversely, during normal market conditions you may be prevented from achieving your objective during any period in which assets are not substantially invested in accordance with your principal investment strategies as a result of being invested in such money market instruments.

**Risks affecting the issuer:** investors in money market instruments are exposed to the political, market and operational risks that affect the issuers of the underlying assets. They are also exposed to currency risk insofar as underlying assets are denominated in a currency other than the one in which their investment was made.

### **Funds**

Funds are collective investment vehicles which pool the funds of investors in order to make investments in accordance with the investment objectives of the fund. Funds can be either open-ended or closed-ended. Open-ended funds are valued on the basis of the value of the assets held. Closed-ended funds are valued on the basis of what investors are prepared to pay/sell.

Investing in funds may involve risks including, but not limited to, the following:

**Market risk:** the value of an interest in a fund depends on the value of the assets it holds. If general market conditions deteriorate, it is likely that the value of the investment in the fund will also deteriorate.

**Liquidity risk:** open-ended funds may not be able to liquidate their assets and return funds to investors in the event that there is poor liquidity in the market generally or in the specific sector in which the fund invests. Ongoing costs to service those investments could lead to increased losses or reduced profits for investors in the fund. Closed-ended funds can be subject to risks of low trading and therefore provide limited liquidity, making it difficult for an investor to realise its investment.

**Interest rate risk:** a leveraged fund will be exposed to interest rate rises. This could reduce the returns that investors receive, or even lead to losses.

**Country risk:** the value of a foreign investment may decline because of political changes or instability in the country where the foreign investment was issued.

**Currency risk:** if investments in the fund are denominated in a currency other than that in which the investor's initial investment was made, returns could be reduced (or losses incurred) due to currency fluctuations.

**Counterparty risk and service provider risk:** the insolvency of any institution providing services to the fund, such as safekeeping of assets or acting as counterparty to the fund in derivatives or other instruments, may expose the fund to financial loss.

**Derivatives risk:** a fund may utilise instruments in the form of warrants, futures, options, forward contracts and swaps to seek to enhance investment returns. While this can potentially have the effect of enhancing the fund's performance, it can also be detrimental if there are losses on the derivatives.

**Operational risk:** an investment in a fund can involve operational risks arising from a wide range of possible operational errors, including system breakdowns, human errors or external events and errors caused by service providers such as the investment manager, which may affect the value of the fund and (if applicable) its ability to pay redemptions within the scheduled timeframe.

**Limited diversification risk:** unless the fund is subject to investment restrictions and diversification requirements, the number and diversity of investments held by a fund may be limited.

**Restrictions on subscription:** an investor in the fund's units/shares may be prevented from subscribing and redeeming such units/shares, either at the official net asset value (for example, as a result of the imposition of any charges by the fund) or at all, or the prescribed notice period, timing cut-offs and minimum/maximum amounts in respect of subscriptions and redemptions for the fund's units/shares may be changed.

**Compulsory redemption risk:** the fund may compulsorily redeem the shares/units upon the occurrence of certain events.

**Performance risk:** no assurance can be given relating to the present or future performance of a fund and any underlying asset or instrument in which the fund may invest, that any analytical model used by the fund will prove to be correct or that any assessments of the short-term or long-term prospects, volatility and correlation of the types of investments in which a fund has or may invest will prove accurate.



**Changes to portfolio:** the composition of the fund's portfolio of investments may change from time to time. Such changes may have an impact on the value of the fund.

**Sub-funds segregation:** the sub-funds of the fund may be segregated as a matter of the law of the fund's home jurisdiction and, as such, the assets of one sub-fund will not be available to satisfy the liabilities of another sub-fund. However, the fund may operate or have assets held on its behalf or be subject to claims in other jurisdictions other than its home jurisdiction which may not necessarily recognise such segregation. There can be no guarantee that the courts of any jurisdiction outside its home jurisdiction will respect the above limitations on liability.

**Cyber security risk:** where an issuer of securities, in which a fund may invest, is exposed to cyber security breaches, this could result in material adverse consequences for the issuers, potentially causing the fund's investment to lose value.

### **AIFs**

Alternative Investment Funds ("**AIFs**") are vehicles which pool investments but are not restricted by statute as to instrument restrictions, so no investor protection arrangements are in force. Investments in an AIF may be exposed to the following:

**Asset allocation:** AIFs can invest in a very wide range of investments. Some AIFs will invest in highly speculative or very illiquid assets; this may increase the risk of losing some or all of the investment in the AIF or making it difficult to relive the value of the investment.

**Leverage risk:** AIFs can be highly leveraged. This means that small falls in the value of the investments they hold can have significant impact on the value of the fund.

**Liquidity risk:** some AIFs have lock-up periods or may otherwise be illiquid, so realising your investment can be difficult.

**Limited diversification risk:** AIFs may not be subject to investment restrictions and diversification requirements, and therefore they may have limited diversification meaning that an investor may be highly exposed to poor market conditions in the relevant sector.

### **UCITS**

Undertakings for Collective Investment in Transferable Securities ("**UCITS**") may only invest in certain assets (transferable securities, units in Collective Investment Schemes (any arrangement in respect of any property (investment), such as money, the purpose of which is to enable persons taking part in such arrangement (whether by becoming owners of the property or otherwise) to participate in profits/income arising from the property, including income), certain money market instruments, derivatives and forward transactions and deposits). Investments in UCITS may be subject to the following risks:

**Limited diversification risk:** as UCITS can only invest in certain assets, they are therefore highly exposed to market conditions affecting those investments.

**Liquidity risk:** interests in UCITS are intended to be easily transferable and redeemable, but in the event of poor performance of the fund, liquidity may be drastically reduced and investors may be unable to realise their investments without incurring losses or reduced returns.

### **ETFs**

Exchange-traded funds ("**ETFs**") are funds that are traded on an exchange. Investments in ETFs may be exposed to the following risks:

**Market risk:** typically, an ETF will seek to replicate a stock market index, market sector, commodity or other basket of assets. Accordingly, the investor is exposed to the market risk of the underlying assets.

**Performance risk:** investors in an ETF may rely on the manager to track the performance of the underlying indices or assets, or the ETF may track the underlying assets passively (i.e. without the active involvement of the manager). In practice, the ETF's performance will differ from the performance of those indices or assets. More specifically, this may be the result of an ETF tracking error (being the difference between the returns of the ETF and its reference index or asset) may occur owing to a number of factors including rebalancing, restrictions/limitations (e.g. emerging market accessibility), method of replication and the costs/expense ratio (higher costs may lead to a greater tracking error). Therefore, an investor may receive lower returns than it would have had it invested directly in those underlying assets.

**Derivatives risk:** ETF managers may employ a synthetic structure to provide the stated return, whereby the return is based on a derivative executed with a counterparty. The return may therefore be dependent on the credit quality of the counterparty and/or the collateral held to support the position. Investors may also be exposed to the risks outlined below in respect of derivatives.

**Authorised participant (AP) concentration risk:** in the ETF market, only an AP is permitted to engage in the creation/redemption of transactions directly with the ETF. Since the ETF may only permit for a limited number of institutions to act as an AP, there is the risk that, where an AP exits the business, or is otherwise unable to proceed with the creation/redemption transactions, it was instructed to carry out, and no other AP is able to step in to give effect such creation/redemption transactions, the ETF shares/units may be more likely to trade at a premium price or a discount to the net asset value of index or assets it seeks to replicate, and as a result the ETF may be subject to trading halts and/or delisting.

**Index-linked risk:** an ETF may seek to track and replicate a specific index (e.g. a stock index) to achieve returns that correspond to value of that underlying index.

### *Money Market Funds*

A money market fund (“**MMF**”) is a fixed income fund that invests in debt securities with short maturities and minimal credit risk. Money market funds are generally a very low-volatility type of investment. Investments in MMFs may be subject to the following risks:

**Credit risk:** there is no guarantee that the original investment will be recouped when the investment is redeemed. The investor is exposed to the credit risk of the underlying issuers and the credit, market, liquidity and political risks which affect them.

**Inflation risk:** MMFs are designed to be a safe, short-term investment, so returns tend to be lower than those of more volatile investments. This creates the risk that the rate of return may not keep pace with inflation, resulting in a negative return in real terms.

**Redemption risk:** typically, MMFs will be redeemed at par on a daily basis, but in times of extreme stress, MMFs have suspended redemption requests.

### *Repo and Stock Lending*

Under a repurchase transaction (“**Repo**”), the parties enter into two simultaneous transactions: (i) one party (the “**Seller**”) transfers title to securities to the other party (the “**Buyer**”) for immediate settlement (or for settlement on a forward start date) at an agreed purchase price paid by the Buyer to the Seller, and (ii) with the agreement for the Seller to repurchase equivalent securities from the Buyer on a specified future date, or on demand, at an agreed repurchase price (representative of the purchase price plus the ‘Price Differential’ or ‘repo rate’ reflective of the financing charge during the term of the Repo).

Under a stock lending transaction, one party (the “**Lender**”) transfers title to securities (normally equities) to the other party (the “**Borrower**”) for a defined period of time, or open and terminable on demand, in return for a fee paid by the Borrower to the Lender during the term of the loan (based on market value of the securities). The Borrower provides cash or securities collateral (by way of title transfer) to the Lender on commencement of the loan. On termination of the loan, the Borrower delivers equivalent securities to the Lender and, simultaneously, the Lender returns to the Borrower any collateral provided by the Borrower.

Repo transactions are generally short-term, with the term ranging from overnight to one year, and can also be used for structured financing transactions with a longer term to maturity.

Repo/Stock Lending transactions may be subject to the following risks:

**Credit risk:** a party to a repo or stock lending transaction is exposed to credit risk –its counterparty may become insolvent or otherwise unable to meet its obligations and such party may not be adequately collateralised in order to mitigate this counterparty credit risk.

**Settlement Risk:** operational risk may arise due to the non-settlement or delay in settlement of securities, or failure to deliver securities due to illiquid market conditions in respect of the specific securities at any given time, with the securities difficult to source. Delivery failure could result in an event of default and termination of the repo or stock lending transaction.

**Market Risk:** the economic risks and rewards remain with the Seller (or Lender). Therefore, there is also a potential opportunity cost to a repo or stock lending transaction. If the value of the securities transferred to Buyer (or Borrower) has fallen before equivalent securities are returned, the Seller (or Lender) may have missed the opportunity to dispose of those securities for a higher price which may exceed the price received for the use of its securities under the transaction.

**Interest Rate Risk:** for longer-dated repos, there can be interest rate risk, in that parties are locked into paying/receiving a specific interest rate that is higher/lower than the prevailing rate.

**Collateral:** repo and stock lending transactions also involve risks relating to the re-use of collateral provided to the counterparty.

### *OTC Derivatives*

A derivative is a contract entered into between parties for the exchange of payments calculated by reference to an underlying asset, rate or index. A derivative can be traded “over-the-counter” (i.e. outside of an exchange or other trading venue) (“**OTC**”) or on an exchange (“exchange-traded”).

In general, OTC derivatives involve the following risks:

**Market Risk:** as derivatives are priced on the basis of an underlying asset or other value, the client will be exposed to the market risks that affect the underlying. However, the economic return of a derivative transaction may not be identical to the economic return of holding the underlying, and may include an adjustment for fees or commissions, financing charges, hedging costs or break costs. ‘Stop loss’ or ‘stop limit’ orders intended to limit losses may not be effective if market conditions make it impossible to execute such orders

**Counterparty credit risk:** where the derivative transaction is uncleared and uncollateralised, the counterparties are exposed to the credit risk of the other party. The client’s entire investment could be lost in the event of default by, or the insolvency of, its counterparty.

**Loss of investment:** there is a risk that the client will pay an upfront amount, but never receive any benefit from the transaction. An example of this could be if an option purchased is not in-the-money at the time it can be exercised.

**Contingent liabilities:** derivatives such as credit default swaps or options may involve contingent liabilities. This can result in the client incurring losses much greater than its original investment (if any) or premium received (in the case of sold options) should certain conditions be met, such as the occurrence of a credit event or an asset reaching a strike price.

**Unlimited loss:** losses under certain derivatives can theoretically be unlimited. In the context of an interest rate or FX swap, for as long as the interest or exchange rate continues to rise, so too will the client’s loss if it is required to pay the variable rate under the transaction.

**Leverage risk:** derivatives may be entered into on a highly geared or leveraged basis. This may mean that even a relatively small movement in the value of the underlying asset or other specified factor(s) could result in a disproportionately large movement, unfavourable or favourable, in the amount payable between the parties to the transaction.

**Legal risk:** if a counterparty goes into default and the derivative is terminated, the ability to recover value from the transaction is ordinarily dependent on netting gains against losses across different transactions and the value of the transactions against the value of the collateral. If the legal netting mechanism is not recognised in any jurisdiction, it may be that losses will be incurred.

**Collateral risk:** parties to derivatives contracts are often required to post collateral to mitigate their credit exposure to one another. If the market value moves against their position, the investor may be called upon to pay substantial additional collateral on short notice. Failure to post collateral may lead to the contracts being closed out, which could crystallise a loss position. There is no guarantee that collateral which is posted by the client will be returned to the client. Where collateral is held by a third-party custodian, the return of such collateral is subject to the credit and operational risk of that custodian.

**Basis risk:** where a derivative transaction has been entered into to hedge price or other risks arising from ownership of a particular underlying, the performance of the derivative and the performance risk of the underlying may not be perfectly correlated, resulting in residual ‘basis’ risk.

**Operational risk:** losses may occur due to the failures of processes and systems used in monitoring derivative transactions, including calculating and making payments or deliveries, exercising rights (such as options rights) before their expiry, monitoring lifecycles events and delivering notices in a timely manner. Such failures in third party systems may be subject to limitations on liability.

**Delivery risk:** if you have entered into a physically settled derivative, you may be obliged to deliver/take delivery of the relevant asset. In respect of commodities and natural resources, this may require significant operational resources to achieve.

**Early termination:** derivative transactions may be subject to early termination due to a voluntary or agreed early termination, ‘events of default’ or ‘termination events’ in relation to the client or the provider (e.g. failure to pay, insolvency, force majeure, illegality, tax events) or extraordinary events relating to the underlying (e.g. merger nationalisation or delisting of an equity, market disruptions, cancellation of an index, disruptions in the ability of one or more parties to hedge the transaction). Such events (with the exception of voluntary or agreed early termination) may be outside the control of the client and such termination may, depending on the value of the transaction at such time, result in a substantial payment due from/to the client (even where the provider is in default or the termination arises from an external event). Clients may not be able to establish replacement transactions, or may incur significant costs in doing so, such as charges for early termination even where such early termination is voluntary or agreed between the parties.



**Liquidity risk:** uncleared derivative contracts can be amended or transferred only pursuant to their express terms or by agreement of the parties. Where consent of the dealer to transfer or unwind an OTC derivative transaction is required, it may not provide such consent, for reasons which it is not obliged to disclose. In addition, there may not be another dealer who is willing to provide the same or a similar transaction. OTC derivative transactions on standardised terms (e.g. credit default swaps with set payment dates and maturity dates) will be more liquid than bespoke transactions. OTC derivative transactions may involve greater risk than investing in exchange-traded derivatives (see section 2.8 below) because there is no exchange market on which to close out an open position. It may therefore be impossible to liquidate an existing position, to assess the value of the position arising from an off-exchange transaction or to assess the exposure to risk.

**Risk of Adjustments:** the occurrence of certain events relating to the underlying of the derivative transaction may trigger the right of the calculation agent to make certain adjustments to the economic terms (e.g. market disruption events, stock splits, or the payment of unexpected or extraordinary dividends, currency controls, cessation of a benchmark). Such adjustments may involve an element of discretion on the part of the calculation agent. Exposure to an underlying via a derivative may not correspond in all cases with exposure obtained by holding the underlying directly.

**Clearing risk:** cleared OTC derivatives are OTC derivatives which have been submitted to and accepted for clearing by a clearing house. Such cleared derivatives are subject to the rules of the clearing house, including collateral arrangements required by the clearing house. Therefore, participants may be required to post collateral on short notice to cover losses incurred under the cleared OTC derivative contracts. Failure to post collateral may lead to the contracts being closed out, which could crystallise a loss position. The terms and conditions of cleared OTC derivatives contracts (including the strike or forward price) may be modified by the clearing house without notice to reflect changes or events in respect of the underlying asset or otherwise.

**Changes to exchange or clearing house rules:** the terms and conditions of OTC derivatives contracts (including the strike or forward price) may be modified by the exchange or clearing house to reflect changes or events in respect of the underlying asset or otherwise.

### **Swaps**

Transactions in swaps involve an exchange of different cash flows between the parties. Parties are exposed to the market risk of the relevant underlying. For example, an interest rate swap may involve one party paying the other a variable rate of interest in exchange for payment by the other party of a fixed rate of interest, each calculated on the same notional amount. The party that pays the variable rate of interest will be exposed to the risk of a rise in the variable interest rate, but will benefit from a fall in that interest rate. The receiver of the variable rate of interest will be exposed to the risk of a fall in the variable interest rate, but will benefit from a rise in that interest rate.

An investor purchasing exposure to an underlying asset via a swap will also have funding costs to pay to its counterparty, thereby increasing the potential loss or reducing profits.

### **Credit Default Swaps**

A credit default swap is a contract under which one party (the buyer of credit protection) pays regular fixed amounts to the other party (the seller of credit protection) in return for a payment upon the occurrence of a 'credit event' (e.g. payment default, insolvency, restructuring) in respect of the underlying reference entity or entities, linked to the loss incurred by a holder of debt of the reference entity (typically calculated by reference to a recovery rate determined via an auction process run by ISDA).

The performance of standard credit default swaps is significantly influenced by the ISDA Credit Derivatives Determinations Committees (as the same may be reconstituted from time to time) ("**Determinations Committee**"), which make binding decisions on critical issues such as whether a credit event has occurred, whether there is a successor to the specified "reference entity" underlying the credit default swap, which obligations of the reference entity are deliverable, the terms of an auction to determine the recovery price and whether or not an auction will be held. The procedures of the Determinations Committee are codified in specific rules, which may be amended by the Determinations Committee.

None of ISDA (or any successor organisation overseeing the Determinations Committee), the institutions serving on the Determinations Committee or any external reviewers owes any duty to participants in credit default swaps in relation to the activity of the Determinations Committee. Institutions serving on the Determinations Committee may base their votes on information that is not available to participants in credit default swaps.