

Edition 2001

# Special Risks in Securities Trading

Should you have any suggestions with regard to future editions of this information brochure, please send them to: [office@sba.ch](mailto:office@sba.ch). We are interested in your feedback which we will evaluate at the earliest opportunity.

Swiss Bankers Association

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# Introduction

Since 1 February 1997, commercial trading in securities has been subject to the **Stock Exchange Act** (Swiss Federal Act on Stock Exchanges and Securities Trading of 24 March 1995). Against the background of securities dealers' duty of information towards their clients as laid down in the Stock Exchange Act, this brochure is intended to provide information concerning the types of trading and investments which can involve special risks. <sup>1</sup>

References to securities dealers should be understood as references to your bank.

## Securities and the Risks Involved

What are securities?

Securities are defined as standardised certificates which are suitable for mass trading, as well as rights not represented by a certificate but with similar functions (book-entry securities). They include equities, bonds, units of mutual funds and derivatives. Securities are regarded as standardised or suitable for mass trading if they are offered to the public in a standardised form and denomination, or are sold to more than 20 buyers. <sup>2</sup>

What are derivatives?

Derivatives are financial contracts for which the price is derived either from equities, bonds, commodities or precious metals, or from benchmarks such as currencies, interest rates and indices. <sup>3</sup>

Hence, for example, an equity option derives its value from the "underlying" equity. In the following chapters, we will go on to look at **different types of derivatives**, including forwards, futures and combinations as well as options. <sup>4</sup>

Which areas of securities trading require particular attention?

Securities, and especially derivatives, entail **financial risks**. Derivatives are financial instruments based on an underlying, and are sometimes composed of different elements. This often makes them difficult to understand. This is particularly true for “exotic” options. This brochure goes on to explain these financial instruments and their associated risks. However, it is no substitute for the product descriptions published by their issuers. Your securities dealer will be happy to answer any **further questions** you may have. 5

Can risks be unlimited?

There are basically two types of investment: those with **limited** and those with **unlimited** risk. The purchase of equities or options involves limited risk. At worst, the entire amount of the capital invested is lost. 6

**CAUTION**

On the other hand, there are certain types of derivatives that can require an additional outlay of capital over and above the original investment. This obligation to make such margin payments can amount to many times the original level of the investment. Unlimited risk is particularly associated with 7

- writing an unlimited call option
- writing a put option or
- forwards and futures.

If, in such cases, you wish to limit or reduce the level of risk, we recommend you take special precautions at the time you make the investment (especially by hedging against potential losses using forwards or futures). Carefully read this important point in your issuer’s product information brochure or contact your securities dealer.

## **Your Right to Information from Your Securities Dealer**

What right do you have to information?

The Stock Exchange Act obliges securities dealers to inform their clients about the risks associated with a given **type of transaction**. Section one of this brochure deals with this area. 8

The obligation to inform is dependent on the **client’s level of experience and specialist knowledge in the area concerned**. Clients must be informed as to the types of transaction that entail higher levels of risk or have a complex risk profile, but not about the specific risks relating to individual transactions. 9

Section one of this brochure explains the risks surrounding typical derivatives currently available. Section two deals with non-traditional investments (especially hedge funds) and investments in the emerging markets. These instruments are included on account of their increasing significance. The appendix lists and defines terms used in this brochure. 10

## The Scope of Securities Dealers' Obligation to Provide Information

When is your securities dealer's information superfluous?

If you are already familiar with the risks pertaining to a particular type of transaction, you may choose not to receive this information from your securities dealer. You must sign a **written declaration** stating that you wish to dispense with the provision of information **before the transaction is executed**. 11

What information are securities dealers not obliged to supply?

Securities dealers are not obliged to inform you about **normal risks**. These are not covered in this brochure. Here, normal risks are defined as: 12

- **The risks attached to traditional, widely held forms of investment, such as equities, bonds and units in mutual funds**

For example, an issuer can get into financial difficulties, making him/her incapable of payment (default and del credere risks). 13

- **Country risks**

A country risk can arise if a country hinders securities trading by imposing economic sanctions or currency restrictions. 14

- **Development risks**

Development risks apply to new or new-style industries (e.g. information services). These sectors are represented in the "New Markets". 15

Furthermore, the Stock Exchange Act does not lay down an obligation to provide general information concerning the risks of **investing in non-traditional funds and emerging markets**. Given the increasing significance of these types of investment, we nonetheless explain the risks typically encountered in these markets in section two of this brochure. 16

This publication does not deal with the issues of **taxation or any other legal consequences** pertaining to securities transactions (e.g. duties of disclosure). We advise you to look into these matters yourself or to contact your securities dealer. 17

Please read through this brochure carefully and consult your securities dealer if you have any questions. 18

# 1 | Section One: Transactions Involving Special Risks

## Options

What rights and duties do you have?

As the **buyer** of an **option**, you may buy (**call option**) or sell (**put option**) a specified amount of an **underlying asset** (the underlying) at a predefined price (**strike price**) up until a set time (**expiration date**). The price you pay for this right is called the "**premium**". 19

As the **seller (writer)** of an option, you must sell the underlying to the buyer at the strike price up until the expiration date (call option) or you must buy the underlying from him/her at the strike price (put option). This is regardless of the current market value of the underlying. 20

What possible underlying assets can options be based on?

The following can underlie an option: 21

- assets such as equities, bonds, commodities and precious metals
- benchmarks such as currencies, interest rates and indices
- derivatives or
- any combination of the above.

What are American- and European-style options?

It is possible to exercise **American-style** options on any trading day up until the expiration date. 22

It is only possible to exercise **European-style** options on their expiration date. This does not, however, limit their tradability on the secondary market (e.g. on a stock exchange). 23

What is physical settlement, and when is settlement in cash?	
The buyer of a call option with <b>physical settlement</b> can demand physical delivery of the underlying asset from the counterparty (option writer) at the time the option is exercised. In the case of put options, the option writer must physically take receipt of the underlying asset.	24
An option involving <b>cash settlement</b> is settled as a cash amount equal to the difference between the strike price and the current market value of the underlying asset.	25
What is meant by – in the money, – out of the money, – at the money?	
A call option is <b>in the money</b> if the current market value of the underlying is higher than the strike price. A put option is <b>in the money</b> if the current market value of the underlying is lower than the strike price. An option which is in the money is said to have an <b>intrinsic value</b> .	26
A call option is <b>out of the money</b> if the current market value of the underlying is lower than the strike price. A put option is <b>out of the money</b> if the current market value of the underlying is higher than the strike price, meaning it has no intrinsic value.	27
If the current market value of the underlying is equal to its strike price, the option is <b>at the money</b> .	28
How is the value/price of an option determined?	
The price of an option depends on its intrinsic value and on what is referred to as the <b>time value</b> . The latter depends on a variety of factors, especially the remaining life of the option and the volatility of the underlying. The time value of an option reflects the chance that it will be in the money. Hence, the time value is higher for options with a long duration and a very volatile underlying. The same is true for options that are at the money.	29
What are the different types of options?	
– <b>Warrants</b> are options in securitised form. They can be traded on-exchange or over the counter (OTC).	30
– <b>Traded options</b> are non-securitised, but are traded on-exchange.	31
– <b>OTC (over-the-counter) options</b> are neither securitised nor traded on-exchange. Rather, they are agreed directly off-exchange between the writer and the buyer. <b>Closing out</b> an option position prior to its expiration date requires a corresponding offsetting trade between the same parties. OTC options with precious metals and currencies as their underlying are offered publicly as standardised products. In contrast, <b>tailor-made OTC options</b> are specially created for individual investors.	32
What is margin cover?	
The writer of an option must deposit either the corresponding amount of the underlying asset or another form of collateral for the entire duration of the contract. The actual level of this collateral or <b>margin</b> is determined by the securities dealer. The bourse stipulates a minimum margin for traded options. If the <b>margin cover</b> proves insufficient, the securities dealer is at liberty to demand <b>additional cover</b> .	33
What risks are you taking on board as buyer of an option?	
Generally speaking, if the value of the underlying asset falls, so does the value of your <b>call option</b> . The value of your <b>put option</b> tends to fall if the underlying asset rises in value. The less your option is in the money, the larger the fall in the option's value. In such cases, value reduction normally accelerates close to the expiration date.	34

The value of your call option can also drop when the value of the underlying remains unchanged or rises. This can happen as the time value eases or if supply and demand factors are unfavourable. Put options behave in precisely the opposite manner. 35

**CAUTION**

You must therefore be prepared for a potential loss in the value of your option, or for it to expire entirely without value. In such a scenario, you risk losing the whole of the premium you paid. 36

**Call and put options** on futures incur the same risks. Consult the section on forwards and futures for more information. 37

What risks are you taking on board as 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 rises above 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. The underlying assets must be 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 subject to the same risks as when writing an uncovered call option (see below). 38

What risks are you taking on board as 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. 39

**CAUTION**

Since the market value of the underlying can move well above the strike price, your potential loss cannot be determined and is theoretically unlimited. 40

As far as American-style options in particular are concerned, you must also be prepared for the fact that the option may be exercised at a highly unfavourable time when the markets are against you. If you are then obliged to make a physical settlement, it may be very expensive or even impossible to acquire the corresponding underlying assets. 41

You must be aware that your potential losses can be far greater than the value of the underlying assets you have lodged as collateral (margin cover). 42

What risks are you taking on board as 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. Your potential loss corresponds to the difference between these two values. 43

As writer of an American-style put option with physical settlement, you are obliged to accept the underlying assets at the strike price, even though it may be difficult or impossible to sell the assets and may well entail substantial losses. 44

Your potential losses can be far greater than the value of the underlying assets you have lodged as collateral (margin cover). 45

What are combinations?

If you acquire two or more options, based on the same underlying, which differ in either the option type (call or put), the quantity, the strike price, the expiration date or the type of position (buy or sell), this is referred to as a **combination**. 46

Given the large number of possible combinations, we cannot go into detail here about the risks involved in any particular case. Before entering into any such transaction, be sure to consult your securities dealer about the particular risks involved. 47

What are exotic options?

Unlike **“plain vanilla” put and call options** described above, **exotic options** are subject to additional conditions and agreements. Exotic options come in the form of tailor-made OTC options or as warrants. 48

Given the special composition of exotic options, their price movements can vary markedly from those of their “plain vanilla” cousins. 49

You must also be aware that larger transactions can trigger price movements even shortly before expiration and that these can render an option worthless. 50

There is no limit to the structures exotic options may take. We cannot go into detail here about the risks involved in any particular case. Before buying any exotic options, be sure to seek comprehensive advice about the particular risks involved. 51

Which exotic options are encountered in practice?

The following examples of exotic options entail an especially high level of risk. The risks described thus far apply here as well. 52

### **Path-dependent Options**

For **path-dependent options**, unlike “plain vanilla” options, it is not just on expiration or exercising of the option that the market value of the underlying is important. You therefore need to take into account fluctuations in the market value of the underlying during the life of the option when contemplating such an investment. The following are examples of path-dependent options: 53

#### **– Barrier options**

Exercise rights for **knock-in barrier options** only arise if the market value of the underlying reaches a fixed threshold (barrier) within a specified period. Exercise rights for **knock-out barrier options** expire if the market value of the underlying reaches the specified barrier during the given time period. 54

**Double-barrier options** have both an upper and a lower barrier and may take the form of knock-in and knock-out barrier options. 55

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. 56

#### **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 in their entirety and for all time (knock-out/kick-out option). 57

## – Payout options

**Payout options** accord the right to payment of a fixed amount agreed in advance. 58

In the case of a **digital** or **binary option**, payment occurs if the market value of the underlying reaches a fixed value once during a specified time period (**one-touch digital option**) or precisely on the day of expiration (**all-or-nothing option**). For the one-touch digital option, payment occurs either immediately the barrier is reached or on the date of expiration (**lock-in option**). 59

With **lock-out options**, the fixed payment only occurs if the market value of the underlying does not reach the agreed barrier during a specified time period. 60

### CAUTION

The writer of a payout option owes you the full amount of the fixed payment if the barrier is reached, regardless of whether or not the option is in the money when exercised or on the expiration date, or to what extent. This means that the amount owed can be considerably larger for the writer or considerably smaller for the buyer than the option's intrinsic value. 61

## – Asian options

For Asian options, an average value is derived from the market value of the underlying over a specified time period. This average is used to fix the underlying's value for an **average-rate option** and for calculating the strike price for an **average-strike option**. 62

### 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. 63

For an average-strike option, the average strike price of a call option can be considerably higher than the price originally agreed. For an equivalent put option, the strike price can similarly be lower than the price originally agreed. 64

## – Lookback options

The market value of the underlying is recorded periodically over a specified time period for a **lookback option**. 65

For a **strike-lookback option** the lowest value (call option) or the highest value (put option) of the underlying becomes the strike price. 66

The strike price remains unchanged for a **price-lookback option**, with the highest value (call option)/lowest value (put option) being used in calculating the value of the underlying. 67

### 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. Writers of lookback options must be aware that an option will be exercised at what is the most unfavourable time for them. 68

## – Contingent options

Buyers of a **contingent option** must only pay the premium 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). 69

### CAUTION

You will have to pay the entire premium even if the option is only just at the money or just in the money. 70

### – 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, to bring it in line with the market value of the underlying. Any intrinsic value of the option is **locked in**. All lock-ins arising over the entire life of the option are accumulated. 71

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. 72

#### **CAUTION**

On the expiration date, the writer of a cliquet option is required to pay the buyer all the accumulated lock-ins in addition to any intrinsic value of the option. The writer of a ladder option must pay the buyer the highest lock-in amount, which can be considerably higher than the option's intrinsic value on the expiration date. 73

### Options on Several Underlyings

#### – Spread and outperformance options

Both spread and outperformance options are based on two underlyings. With a **spread option**, the absolute difference in movement between the two underlyings forms the basis for calculating the option's value. By contrast, the value of an **out-performance option** is based on the relative difference, i.e. the percentage improvement of one underlying over the other. 74

#### **CAUTION**

Despite a positive performance of both underlyings, the performance 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. 75

### Compound options

– **Compound options** have an option as their underlying, i.e. they are options on options. 76

#### **CAUTION**

Compound options can have an especially large leverage effect. The writer can be faced with very large obligations. 77

## Forwards and Futures

What rights and duties do you have?

**Forwards and futures** entail the obligation to deliver or take delivery on a specified expiration date of a defined quantity of an underlying at a price agreed on the contract date. 78

#### **CAUTION**

Forwards and futures can involve special risks. They are therefore only suitable for investors who are familiar with this type of instrument, have sufficient liquid assets and are able to absorb any losses that may arise. 79

What is the difference between futures and forwards?

**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. 80

**Forwards** are not traded on an exchange; hence they are referred to as OTC (over-the-counter) forwards. Their specifications may also be standardised; otherwise they may be agreed between the buyer and seller. 81

What possible underlying assets can forward and futures contracts be based on?	82
The following can form the underlying for forwards and futures:	
– assets such as equities, bonds, commodities and precious metals,	
– benchmarks such as currencies, interest rates and indices.	
What is a margin requirement?	83
On buying or (short) selling an underlying asset on the futures market, you must supply a specified <b>initial margin</b> on agreement of the contract. This is usually a percentage of the total value of the contracted instruments. In addition, a <b>variation margin</b> 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.	
<b>CAUTION</b>	
In the event of a book loss, the <b>variation margin</b> can be several times as large as the initial margin. The terms for calculating the variation margin are laid down in the applicable exchange regulations or contract provisions.	84
The investor is obliged to deposit the required initial or variation margin cover with the securities dealer for the entire life of the contract.	85
How is the transaction closed out?	86
The investor is entitled to close out the contract at any time prior to the expiration date. How this is done depends on the type of contract or stock exchange practice. You either sell the contract or agree an offsetting trade with identical provisions. Concluding such an offsetting trade means that the two sets of inverse delivery obligations cancel one another out.	
How is a forward transaction settled?	87
If the contract is not closed out prior to the expiration date, it must be settled by the two parties involved.	
If the underlying is a <b>physical asset</b> , settlement is achieved by its physical delivery or a cash payment.	88
In the case of <b>physical delivery</b> , underlying assets for the full contracted value must be delivered. Where there is a <b>cash payment</b> , only the difference between the contracted price and the settlement price need be paid. Physical delivery thus involves more liquid funds than cash settlement.	89
Normally there is physical delivery. 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, form part of the relevant contract provisions.	90
If the underlying is a reference figure or <b>benchmark</b> , fulfilment by physical delivery is not permitted (except for currencies). Rather, there must be cash settlement.	91
What special risks need to be borne in mind?	92
For <b>forward sales</b> , the underlying must be delivered 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.	
<b>CAUTION</b>	
Theoretically, there is no limit to how far the market value of the underlying can rise. Hence, potential losses are similarly unlimited and can substantially exceed the margin requirements.	93

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 corresponds to the originally agreed price. Potential losses can substantially exceed the margin requirements. 94

In order to limit price fluctuations, an exchange may set price limits for certain contracts. Find out what price limits are in place before effecting forward or futures transactions. This is important since closing out a contract can otherwise be much more difficult or even impossible. 95

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 price in order to fulfil your obligation to effect delivery on the contract's expiration date. 96

What special factors apply to OTC forwards?

The market for standardised **OTC forwards** is generally transparent and liquid. Hence, contracts can normally be closed out without difficulty. There is no actual market for OTC forwards agreed individually, and hence the positions they entail may only be closed out with the agreement of the counterparty. 97

What special factors apply to combinations?

Since **combinations** comprise various elements, the closing out of individual elements can considerably alter the risks inherent in the overall position. Before entering into any such transaction, be sure to consult your securities dealer about the particular risks involved. 98

Given the many possible combinations, we cannot go into detail in this brochure about the risks involved in any particular case. 99

## Structured Products

What are structured products?

**Structured products** are combinations of two or more financial instruments. At least one of them must be a derivative. Together, they form a new investment product. 100

Structured products can be traded either **on-exchange or over the counter**. 101

Every structured product has its own risk profile since the risks of their individual components may be reduced, eliminated or increased. Hence it is particularly important that you are fully aware of the risks involved before acquiring any such product. Such information can be found, for example, in the relevant product literature. 102

What are structured products with capital protection?

**Structured products with capital protection** consist of two elements: a fixed-income investment (especially a bond or a money market investment) and an option. This combination enables the holder to participate in the price movements of one or more underlying assets (via the option or **participation component**) while at the same time limiting potential losses (via the bond or **capital protection component**). The capital protection component may only cover a portion of the capital invested. The participation and protection elements can be separated, depending on the product in question. This allows you to retain or dispose of each individual component separately. 103

What is the purpose of the capital protection component?	
The <b>capital protection component</b> determines how much of the purchase price of the structured product is paid out when it expires. It also fixes the minimum return paid out independent of any price movements in the option component.	104
The capital protection is linked to the nominal value rather than the issue price or the secondary market 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.	105
<b>CAUTION</b>	
Note that the capital protection component can be well under 100% of the capital invested, depending on the product. Capital protection does not therefore mean 100% repayment of the purchase price for all products.	106
What is the purpose of the option component?	
The <b>option component</b> determines how and to what extent the buyer of a structured product with capital protection benefits from price movements in the underlying. In other words, it establishes your potential return over and above the capital protection component.	107
The option component usually comprises one option or a combination of options. The risks this component entails therefore correspond to those of the corresponding option or option combination. Depending on the underlying's market value, it can expire without value.	108
What special risks need to be borne in mind?	
Every structured product has its own risk profile resulting from the interaction of its component risks. Since there is almost limitless potential to combine product elements, we cannot go into detail here about the risks involved in any particular case. Before effecting any such transaction, be sure that you are fully aware of the risks involved. Such information can be found, for example, in the relevant product literature.	109
With structured products, buyers can only assert their rights against the issuer. Hence, alongside the market risk, particular attention needs to be paid to issuer risk. You need therefore be aware that, as well as any potential loss you may incur due to a fall in the market value of the underlying, a total loss of your investment is possible if the issuer should default.	110
Market makers, who in most cases are the issuers themselves, normally guarantee that structured products are tradable. Nonetheless, liquidity risks cannot be excluded.	111
What is the maximum possible loss?	
The maximum possible loss for the buyer of a structured product with capital protection is the difference between the purchase price and the amount of the capital protection.	112
<b>CAUTION</b>	
The market value of a structured product can fall below the level of its capital protection, which can increase the potential loss on a sale prior to expiration. In other words, capital protection is only guaranteed if the investor holds on to the structured product until redemption.	113
The risk associated with the option component is the same as the risk of the corresponding option or option combination. Depending on the underlying's market value, the option component can expire without value.	114

## Synthetic Products: Covered Options and Certificates

- What are synthetic products? 115  
**Synthetic products** are essentially covered options and certificates and are characterised by their identical or similar profit and loss structures when compared with specific traditional financial instruments (equities or bonds). Basket certificates are one example. These are based on a specific number of selected stocks.
- Synthetic products can be traded either **on-exchange or over the counter**. 116
- Note that the risks associated with synthetic products need not be the same as the risks associated with the financial instruments they contain. Hence it is particularly important that you are fully aware of the risks involved before acquiring any such product. Such information can be found, for example, in the relevant product literature. 117
- What is a covered option? 118  
A **covered option** involves the purchase of an underlying asset (equity, bond or currency) and the writing of a call option on that same asset. 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.
- What are synthetic covered options? 119  
**Synthetic covered options** are based on the idea of duplicating traditional covered options. This can only be achieved by means of a transaction. Both the purchase of the underlying asset and the writing of the call option are carried out synthetically using derivatives. The purchase price of such a product is identical to that of the underlying, less the premium received for the sale of the call option. Hence, the synthetic product is sold more cheaply than its underlying.
- What are the risks associated with synthetic covered options? 120  
Unlike structured products with capital protection, synthetic covered options do not contain a hedge against losses 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 is lower than it would be in the case of a direct investment. The option premium thereby limits any loss in 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, you are paid a specified cash amount as settlement. If, however, it is lower than the strike price, you receive physical delivery of the underlying asset. In this case, you carry the full risk associated with the underlying. 121
- What are certificates? 122  
A **certificate** accords a right that is either based on several underlyings or has a value derived from several indicators. This allows you, even for a low capital investment, to achieve diversification over a broad range of investment opportunities or risk factors and so reduce the level of your risk.

The main types of certificate are:

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- **Index certificates.** These reflect a whole market, being based on an official index (e.g. Swiss Market Index [SMI]).
- **Region certificates.** These are derived from a series of indices or companies from a certain region (e.g. Eastern Europe, Pacific, etc.).
- **Basket certificates.** These are derived from a selection of national or international companies active in a certain sector (e.g. biotechnology, telecoms, mechanical engineering), indices, bonds or other underlyings.

Certificates are securitised and have a limited duration.

124

Redemption occurs on expiration and equals

125

- a set amount per index point for an index certificate,
- the difference between the market value on expiration and the strike price for a region or basket certificate.

What are the risks associated with certificates?

Investments in index, region or basket certificates basically involve the same level of potential loss as a direct investment in the corresponding equities themselves. Compared with a direct investment, certificates offer greater risk diversification. However, this does not mean the risk is eliminated – it may simply be transposed onto the market and sector risks. In contrast to a direct investment in equities, certificates do not confer any voting rights nor do they entitle the holder to a dividend payment. Certificates also carry an **issuer risk**, i.e. the credit risk associated with the issuing bank.

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## 2 | Section Two: Additional Information

### Investments in Non-traditional Funds (Hedge Funds and Offshore Funds)

What are non-traditional funds?

**Non-traditional funds** are Swiss and non-Swiss funds or investment companies which differ from traditional equity and bond investments on account of their investment style. 127

What are hedge funds?

The most common form of non-traditional fund is the **hedge fund**, which – in spite of its name – does not necessarily have anything to do with hedging. Many hedge funds aim to make a profit and sometimes take on very high levels of risk. Hedge funds include all types of investment funds, investment companies and partnerships that use derivatives for investment rather than hedging purposes, that can carry out short sales or that can attain significant leverages from the investment of borrowed capital. Additional features of hedge funds are their free choice of investment categories, markets (including emerging markets) and trading methods. Hedge funds generally demand high minimum investments. They offer no more than limited subscription and redemption rights with lengthy notice periods. Portfolio managers of hedge funds receive performance-linked bonuses and often have a personal stake in the fund. 128

What risks do you need to be aware of?

Non-traditional investments can take countless different forms. Hence we cannot go into detail here about the risks involved in any particular case. Before making any such investments, be sure to seek comprehensive advice about the particular risks involved and to carefully study any offers.

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Investment strategies are often high-risk. Due to leverage, a small movement in the market can lead to a major gain, but any losses will also be magnified sharply. The entire amount of your investment can, under certain circumstances, be lost.

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It is not uncommon for there to be little information available concerning a non-traditional investment. Moreover, many investment strategies are highly complex and very difficult to understand. Changes in strategy that can lead to a substantial increase in the level of risk are often virtually overlooked, accorded too little attention or noticed too late.

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The liquidity and tradability of non-traditional investments can vary a great deal. Hedge fund issues and redemptions are often only monthly, quarterly or annually. Fixed holding periods lasting many years are not unusual. Provisions regarding trading frequency and holding periods may change frequently and rapidly. Liquidations can stretch over many years.

132

What are offshore funds?

Many funds in this category have an offshore domicile which earns them the name **offshore funds**. They are subject to less stringent legislation and supervision, which in turn offers poorer investor protection. Problems or delays may also arise in the settlement of buy and sell orders for units in such funds. There is no guarantee that an investor's legal rights will be enforceable.

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## Investments in Emerging Markets

Section one of this brochure dealt with transactions about which your securities dealer must inform you in accordance with the Stock Exchange Act. In this second part, we go beyond the scope of this obligation and offer supplementary information on risks.

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What are the emerging markets?

**Emerging markets** are the markets for securities trading in countries that possess one or more of the following characteristics:

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- a certain degree of political instability,
- relatively unpredictable financial markets and economic growth patterns,
- a financial market that is still at the development stage,
- a weak economy.

Which are the established markets?

The list of emerging markets is constantly changing. According to OECD criteria, the emerging markets are all countries except: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the UK and the US. These countries' markets are described as the **established markets**.

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Which factors should I be especially aware of concerning investments in emerging markets?

There are risks linked to investments in emerging markets that are not encountered in their more established counterparts. This is also the case when the issuer or provider of a product has its headquarters or primary focus of activity in an emerging nation. 137

Investing in the products of such providers is therefore often speculative. Before investing in emerging markets, you should form an impression of them that allows you to assess the risks involved. 138

What are the individual risks involved?

When investing in emerging markets, the following risks should be taken into account. This list is not exhaustive. Depending on the type of investment product, there may be additional risks involved as described elsewhere in this brochure. 139

### **Political Risk**

A government's political inexperience or the instability of the political system increase 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 a dramatic fall in the value of your assets in specific sectors of industry as a result of state intervention or the introduction of state monitoring and control mechanisms. 140

### **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 the established nations. Moreover, 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 monitoring. 141

### **Credit Risk**

Investments in debt paper (e.g. bonds, notes) issued by emerging market governments or companies tend to entail much higher levels of risk than established market debt. This can be due to inferior creditworthiness, a high level of government debt, debt restructuring, a lack of market transparency or a lack of information. It is also much more difficult to assess credit risk due to inconsistent valuation standards and the absence of ratings. 142

### **Exchange Rate Risk**

The currencies of emerging market nations are subject to major, unpredictable swings in value. Furthermore, it is important to note that some countries limit the export of their currency or can impose short-term restrictions. Hedging can help limit losses resulting from currency swings, but they can never be entirely eliminated. 143

### **Market Risk**

The lack of sophistication in monitoring their financial markets can result in poor levels of market transparency, liquidity, efficiency and regulation in the emerging markets. Moreover, high volatility and large price differences are characteristic of these markets. Finally, the inadequacy or absence of regulatory measures gives rise to an increased danger of market manipulation or insider trading. 144

**Market Liquidity Risk**

Liquidity is dependent on supply and demand. The impact on the emerging markets of social, economic and political changes or natural disasters can involve a much more rapid and lasting change to this supply and demand equation than would be the case in the established markets. In an extreme case, illiquidity can be the result. This can make it impossible for the investor to sell his/her investments. 145

**Legal Risk**

The absence or inadequacy of financial market monitoring can lead to investors' legal rights being difficult or impossible to enforce. Moreover, legal uncertainty may exist due to the inexperience of the emerging nation's judiciary. 146

**Settlement Risk**

Certain emerging markets have an array of different clearing and settlement systems or none at all. These are often outmoded and prone to processing errors as well as considerable delays in settlement and delivery. 147

**Shareholder Risk and Creditor Risk**

Legislation to protect the rights of shareholders and creditors (e.g. duties of disclosure, insider trading ban, management responsibilities, minority shareholder protection) may be inadequate or non-existent. 148

# Appendix: Definitions

- All-or-nothing option** 59
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  - Asian option** 62
  - At the money** 26ff.
  - Average-rate, average-strike option** see Asian option
  - Barrier option** 54ff.
  - Basket certificate** see Certificate
  - Binary option** see Payout Option
  - Call option** 19f., 26f., 34f., 38f.
- Capital protection** 103ff.
- Cash settlement** 25, 88ff.
- Certificate** 122ff.
- Clearing and settlement** Combined processing and settlement of securities transactions by the securities dealer, carried out in Switzerland by SIS SEGAINTERSETTLE AG.
- Cliquet option** 71, 73
- Closing out** 32, 86f.
- Code of conduct for securities dealers** Professional rules of conduct issued by the Swiss Bankers Association for securities dealers in Switzerland, describing their duties of information, due diligence and loyalty towards their clients.
- Combinations** 46, 98f.
- Compound option** 76f.
- Contingent option** 69
- Covered option** 118ff.

- Credit risk** 142
- Creditor risk** 148
- Derivative** Financial contract for which the price is derived either from equities, bonds, commodities or precious metals, or from benchmarks such as currencies, interest rates and indices.
- Digital option** see Payout option
- Double barrier option** see Barrier option
- Economic risk** 141
- Emerging market** 16, 134ff.
- Established market** 136
- European-style option** 23
- Exchange rate risk** 143
- Exotic option** 48ff.
- Expiration date** 19f.
- Financial instrument** Generic term for all securities, loan-stock rights and derivatives, including those not suitable for mass trading.
- Force majeure** Events neither party in a transaction can influence or be held liable for, such as natural or man-made disasters, armed conflicts, terrorist attacks, uprisings, employment disputes (strikes and lockouts), embargoes, etc.
- In the money** 26, 29, 34
- Index certificate** see Certificate
- Issuer** 13, 110
- Kick-in, kick-out barrier option** see Barrier Option
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- Legal risk** 146
- Lock-in, lock-out option** see Payout Option
- Lookback option** 65ff.
- Margin, margin cover, variation margin** 33, 83ff.
- Market liquidity risk** 145
- Market maker** A securities dealer who is obliged, either permanently or on request, to maintain firm bid and offer prices for single or several financial instruments.
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<b>Price-lookback, strike-lookback option</b>	see Lookback option
<b>Put option</b>	19f., 26f., 34f.
<b>Region certificate</b>	see Certificate
<b>Securities</b>	Standardised certificates which are suitable for mass trading, as well as rights not embodied in a certificate but with similar functions (loan-stock rights). They include equities, bonds, units of mutual funds and derivatives, and must be offered to the public in a standardised form and denomination, or sold to more than 20 buyers.
<b>Securities dealer</b>	A bank that offers new securities publicly on the primary market on a professional basis, and/or trades securities on the secondary market or creates derivatives which it offers publicly.
<b>Settlement risk</b>	147
<b>Shareholder risk</b>	148
<b>Spread option</b>	74
<b>Stock Exchange Act</b>	Swiss Federal Act on Stock Exchanges and Securities Trading of 24 March 1995, which entered into force on 1 February 1997. It has since undergone changes (see "Systematic Collection of Swiss Law 954.1" containing updates to Swiss laws).
<b>Strike price</b>	19f.
<b>Structured product</b>	100ff.
<b>Synthetic product</b>	115ff.
<b>Time value</b>	29
<b>Traded option</b>	31, 33
<b>Underlying</b>	19ff., 74, 82
<b>Volatility</b>	Breadth of the anticipated fluctuations in the market value of an instrument.
<b>Warrant</b>	30
<b>Writer/seller (of an option)</b>	20, 38f., 43f.



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