

# Information to clients regarding the characteristics of and risk associated with financial instruments

Applicable from 1 January 2022

## As a client, you must be aware that:

- trading in financial instruments takes place at your own risk
- before starting to trade in financial instruments, you must carefully study the firm's general business terms and conditions as well as any other relevant information on the financial instrument in question and its characteristics and risks
- you must immediately scrutinise the contract note and submit any complaints regarding errors
- you are responsible for monitoring changes in the value of the financial instruments in which you have invested
- you must regularly assess your investments and make the necessary changes to adapt these to your investment strategy and risk profile

## Innhold

1. DEFINITIONS
2. TRADING IN FINANCIAL INSTRUMENTS
  - 2.1. Share trading
  - 2.2. Share-like instruments
  - 2.3. Interest-bearing financial instruments
  - 2.4. Derivative instruments
3. RISKS RELATED TO TRADING IN FINANCIAL INSTRUMENTS
  - 3.1. In general regarding risk
  - 3.2. Shares and share-related instruments
  - 3.3. Interest-bearing instruments
  - 3.4. In general regarding the risk related to trading in derivative instruments
  - 3.5. The risk involved in various types of derivative instruments
    - 3.5.1. Options
    - 3.5.2. Call options
    - 3.5.3. Put options
    - 3.5.4. Forward/futures contracts
    - 3.5.5. Contracts For Difference (CFD)
    - 3.5.6. Swap contract
  - 3.6. Standardised and non-standardised derivative instruments
  - 3.7. Clearing
4. MUTUAL FUNDS
5. EXCHANGE TRADED FUNDS AND FUND-LIKE PRODUCTS
6. SHORT TRADING
7. TRADING FREQUENCY AND COSTS
8. LEVERAGED (DEBT-FINANCED) TRADING

## 1. DEFINITIONS

**Financial instruments.** This is a generic term for the assets and liabilities that are traded in the securities market, derivative market and in part currency market and is further defined in section 2-2 of the Norwegian Securities Trading Act.

**Regulated market.** A regulated market is a market for the sale of financial instruments. A regulated market has a licence and is subject to a number of rules and obligations. There is a separate Norwegian Act relating to regulated markets (the Stock Exchange Act).

**Stock exchange.** A stock exchange is a regulated market that has a special licence to operate as a stock exchange and is entitled to use the term "stock exchange" in or in addition to its name.

**Multilateral Trading Facility (MTF).** An MTF is not a regulated market; it is a trading venue for automatic matching of orders in financial instruments. All investment firms that meet the objective requirements set by the MTF may be member of the MTF and take part in its trading. In Norway, operating an MTF requires a licence pursuant to the Securities Trading Act.

**Systematic Internaliser (SI).** An investment firm that carries out extensive own-account trading in shares with clients must register as an SI for the financial instrument in question. An SI is obliged to offer binding bid and ask prices and to notify its clients of these.

**Dark pool.** A marketplace where participants can submit orders that are not shown in an open order book. The orders will be automatically matched if another participant submits a corresponding order.

There is often a requirement that such orders must be a minimum size and that matching must automatically take place at the mid-price, i.e. the average of the best bid and ask prices in the open order book. Some dark pools also allow investors to submit their orders to the pool themselves.

***Underlying assets/underlying financial instrument(s).***

These are the assets or financial instruments that a derivative contract gives the parties the rights and obligations to buy or sell or that the parties have agreed to base a monetary settlement on.

***Option.*** A contract that gives one party (the Holder) for a limited period a right but no obligation to buy (a Call Option) or sell (a Put Option) an agreed volume of financial instruments at a predetermined price from/to the other party (the Writer).

***Forward/futures contract.*** A contract according to which both the buyer and seller agree that an agreed volume of financial instruments will be transferred from the seller to the buyer at an agreed price on an agreed date that is further into the future than the normal settlement period for the underlying financial instrument covered by the contract.

***Price swap.*** A contract linked to an agreed volume of financial instruments, a settlement price (the swap price) and a settlement date, and according to which the underlying financial instruments are not to be delivered but there is instead to be a monetary settlement based on the difference between the swap price and the market price on the expiration date.

***Contract for difference (CFD).*** A contract according to which both the buyer and seller are bound to agree to a monetary settlement of the price developments of an agreed volume of one or a group of financial instruments, indices, currencies or similar. The buyer of a CFD makes a gain if the price rises and a loss if the price falls. A CFD does not have a predetermined

expiration date but the buyer may close the position at any time.

***Credit Default Swap (CDS).*** A contract which provides a buyer with an insurance against the issuer of a debt obligation being unable to settle the debt, in whole or in part, on the settlement date.

***Index option/index futures contract.*** A contract where the underlying asset is an index value, not a security. Such a contract is not settled by delivering financial instruments but by calculating the contract's monetary value.

***Short sale.*** The sale of financial instruments that a party does not own, but has borrowed to carry out settlement on time. The financial instruments are bought at a later date and handed back to the lender. A short sale where the seller has not borrowed the underlying financial instruments is called a naked short sale and is illegal in Norway.

***Securities swap.*** A combination of short and long positions in (at least) two financial instruments, in which the change in the price of one of the instruments (the long position) is netted against the change in the price of the other instrument (the short position).

***Exercising*** an option means demanding the trading of the underlying financial instrument in accordance with the option contract. Normally, the Holder may demand the partial exercise of the option while the option is maintained for the residual quantity.

***The expiration date.*** The date when either a demand to exercise the option must be put forward or the option lapses as being worthless. The expiration date for a forward/futures contract is the date when the contract is changed into a trade with an ordinary settlement period for the delivery of an underlying financial instrument in return for payment of the purchase price.

***The settlement date.*** The date when a forward/futures contract, option or price swap is finally settled by the underlying financial instruments being delivered in return for the agreed purchase price, or the monetary settlement falling due for payment. The settlement date is normally three stock market days after the expiration date.

***American option.*** An option that the Holder may demand to exercise, in whole or in part, at any time prior to the agreed time on the expiration date.

***European option.*** An option that the Holder may only demand to exercise on the expiration date.

***Spot price/rate.*** The price at which the security is traded at for normal delivery on the second stock market day after the trading date.

***Strike price/rate.*** The agreed price or rate for the exercise of an option.

***Forward/futures price/rate.*** The agreed price or rate for the settlement of a forward/futures contract.

***Swap price/rate.*** The agreed price(s) or rate(s) to be used when settling the individual elements in a swap.

***Option premium.*** The amount the Holder has paid the Writer to purchase an option.

***Hedge shares/hedge.*** If the seller of an option, forward/futures contract or swap does not want to have any price risk, he/she buys or short sells a quantity of the underlying securities so that any increase in the value of the sold derivative is offset against a corresponding increase in the value of the underlying securities. The securities that in this way protect the issuer against a price risk are often called hedge shares or a hedge.

***NIBOR interest rate.*** An interest rate that is calculated by the Oslo Stock Exchange according to rules

determined by Finance Norway and states the market interest rate for unsecured loans in NOK. The interest rate is determined daily for various terms to maturity.

**Interest rate risk.** The risk of the financial instrument that the client invests in falling in value due to changes in the market interest rate.

**Credit risk.** The risk of an issuer or a counterparty being unable or less able to pay.

**Clearing.** The function as a counterparty between the parties to derivatives contracts or share trades that guarantees that the parties will receive settlement for the contract/trade.

## 2. TRADING IN FINANCIAL INSTRUMENTS

Trading in financial instruments, such as shares, equity certificates, bonds, certificates, derivatives or other rights and obligations intended for trading in the securities market, normally takes place in an organised form in a trading system.

Trading takes place through the investment firms that use the trading system. As a client, you must normally contact such an investment firm in order to buy or sell financial instruments. There are also investment firms that forward orders to another investment firm that then uses the trading system. Trading may also take place internally in an investment firm, for example by the investment firm becoming the counterparty to the trade or through a trade with another of the investment firm's clients (internal trade).

In a **regulated market**, financial instruments can be **listed**. That means that the instruments are approved for trading and the marketplace monitors that the company which has issued the financial instruments

meets the requirements linked to the listing. Shares, equity certificates, bonds, certificates, some fund units and derivatives linked to financial instruments are traded on the Oslo Stock Exchange.

Trading in listed financial instruments may take place in regulated markets, in an MTF in a dark pool or through an SI.

Information on the prices of the financial instruments traded on a regulated market is published regularly on the marketplace's website, in newspapers and/or through other media.

### 2.1. Share trading

Shares in a limited company entitle the owner to a percentage of the company's share capital. The share entitles the owner to a percentage of the dividends or other amounts distributed by the company. Shares also provide a **right to vote** at the general meeting, which is the company's supreme decision-making body. The more shares an owner has, the larger the owner's percentage normally is of the capital, dividend and votes. The right to vote may vary depending on the share category. There are two types of limited company in Norway, a **public limited company (ASA)** and a **private limited company (AS)**.

Only shares issued by a public limited company (ASA) or a corresponding foreign entity can be listed on a stock exchange in Norway. In addition, there are requirements as to the company's size, business history and ownership spread and the publication of the company's finances and other operations.

Less stringent rules often apply to listing on regulated markets that are not stock exchanges.

In Norway, there are currently two **regulated markets** for trading in shares: Euronext Oslo Børs and Euronext Expand. Only Euronext Oslo Børs is licensed as a **stock exchange**.

Shares may be listed on more regulated markets, so-called secondary listings. Several Norwegian companies have secondary listings on foreign regulated markets.

Trading in Norwegian securities also takes place in a number of MTFs, including Euronext Growth (Oslo).

Trading in shares that are not listed on a regulated market takes place in the so-called OTC market. Here, trading takes place to a large extent based on information about prices and interests that the brokerage firms disclose to each other. In Norway, the brokerage firms can enter interest in buying or selling in a trading support system run by NOTC AS, a company owned by the Norwegian Securities Dealers Association and Euronext. The brokerage firms then enter into agreements to buy/sell over the phone. The companies registered on this list must publish significant price-relevant information in the NOTC's trading-support system. For more information on the NOTC List, refer to [www.vpff.no](http://www.vpff.no).

If a share is not listed on a regulated market or traded in an MTF and does not have buy and sell interests published in a trading support system, it will normally be traded by the brokerage firm trying to assist the client by contacting other clients who may be interested in becoming a counterparty. Investments in this type of shares entail a considerable liquidity risk and significant uncertainty regarding the determination of the price.

Trading in a regulated market or other trading system comprises the **secondary market** for shares and equity certificates that a company has already issued. In addition, the NOTC List functions as a secondary market for shares. If the secondary market functions well, i.e. if it is easy to find buyers and sellers and the offer prices from buyers and sellers and final prices of completed trades are continuously registered, companies benefit from the fact that it is easier to issue new shares and thus raise more capital for the company's operations. The **primary market** is the market where new issues of shares, equity certificates and bonds are offered/subscribed for.

Shares registered on a regulated market or other trading system are normally divided into various groups depending on the company's market value or liquidity. These groups, often called lists or segments, are usually published on the trading system's website, in newspapers and via other media.

The daily key prices at which the shares are traded, such as "highest", "lowest" and "latest", as well as information on the volume traded, are published in the financial press and on various websites run by marketplaces, investment firms and information vendors to the financial industry, among other places. The relevance of this price information may vary, depending on the way in which it is published.

There are various **classes** of shares, usually A and B shares, and these are normally important for the exercise of voting rights at the company's general meeting. Class A shares normally entitle the holder to one vote, while class B shares usually entitle the holder to a restricted voting right or no voting rights at all. The

differences in voting rights may, for example, be due to the fact that, in conjunction with a diversification of ownership, the company wants to protect the original founders' and owners' influence over the company by giving these parties stronger voting rights. For the time being, only a few Norwegian listed companies have different classes of shares

A share's **nominal value** is the amount of the company's share capital that the share represents. The sum of all the shares in a company multiplied by the nominal value of each share constitutes the company's share capital. Occasionally, companies change the nominal value, for example because the market price of the share has risen significantly. By dividing each share into two or more shares, a so-called split, both the nominal value and price of the share are reduced. However, after a split the shareholder's capital remains the same but is divided into a greater number of shares, each of which has a lower nominal value and price.

Conversely, a **reverse share split** may be carried out if, for example, the share price falls dramatically. In such a case, two or more shares are consolidated to form one share. Following a reverse share split, the shareholder's capital remains unchanged but is divided into fewer shares, each of which has a higher nominal value and higher price.

A **stock exchange introduction** means that shares in a limited company are listed and admitted for trading on a regulated market. In connection with this, the general public may be invited to subscribe for (buy) shares in the company. The listing is normally motivated by the company wanting better access to the capital market and improved opportunities for trading in the company's shares.

An **acquisition** normally involves an investor or investors inviting the shareholders of a company to sell their shares on certain terms. A buyer that obtains 90% or more of the share capital and votes in the company can petition for the compulsory purchase of the remaining shares from those shareholders that have not accepted the acquisition offer.

A **mandatory bid obligation** arises when a shareholder becomes such a dominant owner that he can take control over a company. The Securities Trading Act states that this takes place when a shareholder becomes the owner of, or in some other way controls, more than one third of the shares in the company. A mandatory bid obligation arises once more if the dominant owner controls more than 40% and 50% of the shares. Anyone that exceeds such a limit and does not reduce his shareholding to below the limit again as quickly as possible, is obliged to make an unconditional offer to all the company's shareholders to buy their shares at the highest price that the bidder has paid in a given period.

**Share issues** raise new capital for a company. If a limited company wants to expand its operations, it often requires additional capital. It raises this by issuing new shares through a share issue. The main rule in the Norwegian Private Limited Companies Act is that existing shareholders have a pre-emptive right to subscribe for shares in the share issue. The number of shares that can be subscribed for is in such case determined by the number of shares already owned by the shareholder and the company issues subscription rights to existing shareholders. The subscriber must pay a price (the issue price) for the new shares. This price is normally lower than the market price. The

subscription rights will therefore have a certain market value and the price of the shares normally drops correspondingly after the subscription rights have been detached from the shares. Shareholders who have subscription rights but do not subscribe for shares, may during the subscription period (which in a rights issue must be at least two weeks), sell their subscription rights on the marketplace where the shares are listed. After the expiry of the subscription period and allotment of the shares, the subscription rights expire and are thus useless and worthless.

A limited company can also carry out a so-called **private placement**, which is a share issue directed solely at a limited group of investors. In order to carry out a private placement, the shareholders must have decided to relinquish their pre-emptive rights to the new shares at a general meeting. Private placements often take place according to an authorisation given to the company's board by the general meeting. In the case of a private placement, the existing shareholders' percentages of the votes and share capital in the company are **diluted**.

## 2.2. Share-like instruments

Equity certificates, convertible bonds/debentures and depositary receipts may have similar properties to shares. These types of financial instruments are traded on regulated markets, but can also be traded on the OTC market.

**Equity certificates** are very similar to shares. The difference is primarily related to the ownership of the company's assets and influence over the issuer's corporate bodies. There are also some restrictions on the distribution of dividend. The listed equity certificates in Norway are issued by savings banks.

More information on equity certificates is available at [www.egenkapitalbevis.no](http://www.egenkapitalbevis.no).

**Convertible bonds/debentures** are interest-bearing securities which may be exchanged for new issued shares, within a certain period of time and at an agreed price. A convertible bond/debenture is both an interest-rate instrument and a call option. When the conversion rate is much higher than the share's market price, a convertible bond/debenture is normally priced in the same way as any other interest-rate instrument. If the opposite is true, the price of the convertible bond/debenture will reflect both the option value and interest element. In both cases, the price is expressed as a percentage of the nominal value of the convertible bond/debenture.

**Depositary receipts** are a financial instrument that gives the holder all the rights of an owner to an underlying financial instrument that is registered with a custodian. A depositary receipt is normally traded in the same way as the underlying financial instrument.

## 2.3. Interest-bearing financial instruments

An interest-bearing financial instrument is a claim against the issuer of a loan that has not yet fallen due. The return is normally provided in the form of **interest (coupon)**. There are different types of interest-bearing instruments, depending on who the issuer is, the security that the issuer has provided for the loan, the term to maturity and how interest is paid.

Instruments with a term to maturity of one year or less are often called **certificates**, while instruments with a longer term to maturity are called **bonds**.

Many interest-bearing instruments are assessed by independent analysis firms, so-called credit rating agencies. Such an assessment, called a **rating**, is intended to express the default risk on the issuing entity and the rated instrument.

In addition to the rating provided by credit rating agencies, several Norwegian brokerage houses have started to provide so-called shadow ratings. This means that the brokerage house itself assesses the creditworthiness of the issuer and assigns a rating value to the interest-bearing security. The methods used are very similar to those used by the credit rating agencies.

The interest (coupon) is normally paid as either a fixed or floating interest rate. The interest on a fixed-interest loan applies to the entire term of the loan. The interest on a floating-interest loan is normally set (fixed) four times a year for three months at a time based on the NIBOR interest rate and an agreed interest-rate mark-up (interest spread). The interest spread is fixed for the entire term of the loan unless it has been agreed that certain events are to trigger a change. It is not unusual for it to be agreed that the interest spread for loans that are not rated is to change if the loan achieves a predetermined satisfactory rating.

On certain types of loans, no interest is payable and only the nominal amount is repaid on the loan's maturity date (zero coupons). The purchase of zero-coupon bonds takes place at a considerable discount, which means that the effective interest rate is the same as for bonds on which a regular coupon rate is paid. For example, all the debts that the Norwegian state issues in Treasury bills (government certificates) are zero-coupon instruments.

The interest that a borrower has to pay is linked to the market's assessment of the risk of the debt being defaulted on. It is normal to classify loans in two main groups: High Yield and Investment Grade. Interest-bearing securities that credit rating agencies classify as being lower than **bbb** or the equivalent are considered to be more likely to be defaulted on and are therefore classified as high yield securities.

A number of bonds are listed on a stock exchange. The reporting of trades in these financial instruments takes place, like listed shares, on a regulated market. In addition, the Oslo Stock Exchange offers an alternative marketplace for trading in bonds and certificates that are not listed on a stock exchange – Nordic ABM. The Nordic ABM is a separate marketplace that is not regulated by, or subject to a licence, pursuant to the Norwegian Stock Exchange Act but is administered and organised by the Euronext.

Bonds are normally traded in a different way to shares. In practice, the interest and currency market is regarded as a **quoting** or **price-driven market**, unlike the stock market which is an order-driven market.

## 2.4. Derivative instruments

Share options give the Holder the right to buy or sell a share. Acquired (bought) purchase options (call options) give the owner the right to buy, within a certain period, already issued shares at a predetermined price (strike price). Acquired (bought) sales options (put options) give the owner the right to sell shares within a certain period at a predetermined price (strike price). There is an **issued/written** (sold) option corresponding to each **acquired** option.

Index options provide a gain or loss linked to the value of the underlying index and are settled by a cash payment of the difference between the strike price and market price when this difference is in the buyer's favour.

The price of options (premium/price) normally follows changes in the price of the option's underlying shares or index.

Call options with a longer term to maturity than standardised call options are called **warrants**. Warrants may be used to buy underlying shares or to provide a cash settlement if a gain has been achieved as a result of the price of the underlying share being higher than the agreed future purchase price/selling price. Many exchange-traded warrants are issued by investment firms or banks as part of their derivative operations. Warrants can also be issued by the company itself. Such warrants are exercised by the company issuing new shares or selling shares it owns itself.

Derivative instruments are contracts that can be traded on the capital market for financial instruments. The derivative instrument is linked to an underlying financial instrument or an underlying index value.

Derivatives can also have other types of underlying value, such as a currency or commodity, or indices for these. Such derivatives are called currency derivatives or commodity derivatives and are by nature similar to derivatives based on financial instruments. Below, the main focus will be on derivatives based on financial instruments.

Derivative instruments may be used for many different purposes:

- to protect against negative developments in the price of owned financial instruments.
- to achieve a gain on changed market prices without having to own or short sell the underlying financial instrument.
- to achieve a gain or return with a smaller capital investment than that required to carry out a corresponding direct trade in the underlying financial instrument.
- to agree on the sale of securities with settlement in the future.

The price of a call option or a forward/future will usually fluctuate in the same direction as the underlying financial instrument. Investments in derivatives will therefore to a large extent be based on the same assessments as investments in the underlying financial instruments, but an investment in a derivative will produce a risk profile that is different to that of a direct investment.

Investors in the derivatives market can also speculate in changes to secondary parameters that affect the price of the derivative, such as interest-rate changes and the volatility in the market.

In Norway, standardised derivatives are traded on the Euronext Oslo Børs. Derivatives with Norwegian shares and indices as underlying values are also traded on other marketplaces, including the NASDAQ OMX.

Trading in unlisted derivatives takes place on the so-called OTC market. Trading on this market takes place to a large extent on the basis of information regarding prices and interests that the brokerage firms notify

each other of. It is also common for the brokerage firms to carry out own-trading in OTC derivatives and to offer prices and act as counterparties to their clients.

### 3. RISKS RELATED TO TRADING IN FINANCIAL INSTRUMENTS

#### 3.1. General about risk

Financial instruments normally provide a **return** in the form of a **dividend** (shares and fund units) or **interest** (interest-bearing instruments). In addition, the investor may make a gain or loss due to the price of the instrument rising or falling. The total return is the sum of the dividend/interest and change in the price of the instrument.

Naturally, the investor is seeking a total return that is positive, i.e. that produces a **gain**. However, there is also a **risk** that the total return will be negative, i.e. that the investor will make a **loss** on the investment. The risk of loss varies between different instruments. In an investment context, the word risk is often used to express both the risk of loss and the opportunity for a gain. In the description below, however, the word risk is used solely to designate the risk of loss.

There are various ways of investing in financial instruments in order to reduce the risk involved. It is normally better from a risk point of view to invest in several different financial instruments rather than a single one or only a few financial instruments. These instruments should have characteristics so the **risk is spread** and they should not gather risks that may be triggered simultaneously. Investors can also invest in negative positions in instruments (short positions). Such investments will increase in value when the share price falls.

The client personally bears the risk of an investment falling in value and must therefore become acquainted with the terms and conditions, prospectuses, etc., governing trading in such instruments, and with the instruments' individual risks and characteristics. The client must also regularly monitor his/her investments in such instruments. This is the case even if the client has received personal advice in conjunction with the investment. Information for use in monitoring prices and thus changes in the value of the client's own investments may be obtained from price lists published in the media, e.g. newspapers and the internet and, in certain cases, by the investment firm itself.

The client must continuously assess the risk entailed by his investments. Many different factors may affect the value of financial instruments. The client should therefore become familiar with the factors that affect different instruments and be aware of the elements that may affect his own investments. The client should continuously assess his investment portfolio and, if necessary, make changes to adapt it to his investment strategy and risk profile.

#### 3.2. Shares and share-related instruments

The **price** of a share is affected to a great extent by the **company's prospects**. A share price may rise or fall depending on investor analyses and assessments of the company's opportunities to make **future profits**. Future external developments in economic cycles, technology, legislation, competition, etc., may determine the demand for the company's products or services and, consequently, are also of fundamental importance to changes in the price of the company's shares.

The price may also be affected by the **general market risk** – the risk of a fall in prices in the market in general or in certain parts of the market where the client has invested. The price developments for financial instruments listed in **foreign** regulated markets may also affect price developments in Norway.

The price may also be influenced by developments in the sector to which the company belongs – **sector-specific risks** – the risk of a specific sector doing worse than expected or being altered by a negative event so that the financial instruments linked to companies in the sector in question may decline in value. The share price of a company is often affected by changes in the share price of other companies in the same industry/sector irrespective of the country to which the companies belong.

**Other factors directly related to the company**, such as changes in the company's management and organisation, disruptions to production, etc., may also affect the company's future ability to create profits in both the long- and short-term. This is called the **company-specific risk** – the risk of a company doing worse than expected or being affected by a negative event so that the financial instruments linked to the company may fall in value.

The **framework conditions** for industry, both national and international, may also affect share prices. Changes in tax and duty levels nationally and in other countries, affect the companies' cost levels and thus their competitive situation. International agreements between countries regarding customs charges and duties on the import and export of goods and services affect the competition situation that exists between companies and thus also share prices. Major events

such as disasters, terrorist acts and wars may have huge effects on share prices on stock exchanges worldwide.

The **general interest rate level** (market interest rate) also plays a crucial role in share-price developments. If the market interest rate increases, investing in interest-bearing financial instruments may become more attractive so that the players transfer some of their investments from the stock market to the interest-rate market and the demand for shares falls. Normally, share prices fall when demand declines. In addition, share prices are negatively affected by an increase in the interest payable on the company's debts, since this worsens the company's future financial results.

Changes in **foreign-exchange rates** may also affect share prices. Companies whose revenues and costs are in different currencies will be especially vulnerable to such fluctuations. This applies to several Norwegian export companies. When investing in foreign markets, fluctuations in foreign-exchange rates will also affect the result after the purchase or sales amount has been converted into Norwegian krone (NOK).

In the worst case, a company may perform so poorly that it must be declared **bankrupt (in liquidation)**. The shareholders have last priority for receiving any money from the entity in bankruptcy. The company's other debts must first be repaid in their entirety. This results in there only in exceptional cases being any assets left in the company after its debts have been paid, so that the shares in a bankrupt company are normally worthless.

Players in the financial market have different opinions on how share prices will develop, often because they place emphasis on different factors that affect share-price developments or expect the factors that influence the share price to develop in different ways. This means there are both buyers and sellers. If many investors share the same opinion regarding price trends, they will either buy, thereby creating pressure to buy, or sell, thereby creating pressure to sell. Prices increase when there is pressure to buy and fall when there is pressure to sell.

The turnover, i.e. the quantity of a particular share that is traded, affects the share price. In the event of a high turnover, the difference, also called the **spread**, between the price the buyers are prepared to pay (bid price) and the price demanded by the sellers (ask price) is reduced. A share with a high turnover, where large amounts can be traded without any major effect on the price, enjoys good **liquidity** and is thus easy to buy or sell. Shares in companies listed in a generally used benchmark index in a regulated market are normally very liquid.

### 3.3. Interest-bearing instruments

The risk associated with an interest-bearing instrument consists in part of the price changes that may occur during the term to maturity due to changes in market interest rates, and in part of the market's assessment of the risk that the issuer will be unable to repay the loan. Loans for which satisfactory security for repayment have been provided are thus less risky than loans without security.

For loans where the credit risk is considered especially high the issuer has to pay a particularly high interest rate. Such interest-bearing securities are often called **high-yield bonds**.

In the case of bankruptcy or debt settlement proceedings, the owner of an interest-bearing instrument may lose all or some of his investment. In the case of a bankruptcy, all debt must be repaid before the shareholders can receive anything, so in general it can be said that the risk of loss is less in relation to interest-bearing instruments than it is in relation to shares.

The market interest rate is quoted every day for both instruments with short terms to maturity (less than one year), e.g., **certificates**, and instruments with longer terms to maturity, such as **bonds**. This takes place in the money market and bond market. Market interest rates are affected by analyses and assessments conducted by Norges Bank (the central bank of Norway) and other major institutional market players with regard to short-term and long-term trends in a number of economic factors, such as inflation, the state of the economy and interest rate changes in other countries.

If the market interest rate increases, the price of interest-bearing financial instruments will fall since the return on the instrument compared to the market interest rate has become less favourable. Conversely, the price of already issued instruments increases when the market interest rate declines.

Loans issued by the Norwegian state, county councils or municipalities (or guaranteed by such organisations) are deemed to be more or less risk-free with respect to

redemption at the predetermined value on the due date.

### 3.4. Risk related to trading in derivative instruments

Trading in derivative instruments is linked to special risks in addition to the risks linked to the underlying financial instrument. The client bears this risk and must find out all about the derivatives' properties as well as about the terms and conditions in the form of the general terms and conditions, prospectuses or suchlike that apply to trading in such instruments. The client must also constantly monitor his investments (positions) in such instruments. Monitoring information may be obtained from price lists on the internet, the mass media and the client's investment firm.

Trading in derivative instruments can be described as trading in, or a transfer of, risk. For example, a party that expects prices in the market to fall can buy put options that increase in value if the market drops. To reduce or avoid the risk of a fall in share prices, the buyer pays a premium, i.e. what the option costs. Trading in derivatives is in many cases not advisable for clients with little or limited experience of trading in financial instruments, since trading in derivatives often requires specialist knowledge. The structure of a derivative instrument means that developments in the price of the underlying asset affect the price of the derivative instrument. This price effect is often stronger in relation to the investment than the change in the value of the underlying asset. The price effect is therefore called the gearing effect and may lead to a greater gain on invested capital than if the investment had been made directly in the underlying asset. On the other hand, the gearing effect may lead to the loss on the derivative instrument being greater than the relative

change in the value of the underlying asset. Changes in the price of the derivative instrument and of the underlying asset must therefore be closely monitored. The client should, for his own sake, be prepared to act quickly, often that same day, if the investment in the derivative instrument starts to develop negatively.

A party that incurs an obligation by issuing/writing an option or entering into a forward/futures contract must provide collateral for his position right from the start. The requirement for collateral changes as the price of the underlying asset rises or falls so that the value of the derivative instrument rises or falls. Additional collateral may therefore be required. The gearing effect thus also influences the collateral requirement, which may change rapidly and radically. If the client does not provide sufficient collateral, the clearing organisation or investment firm is entitled to terminate the investment (close the position) without the client's consent in order to reduce its risk. A client should thus closely monitor price developments and the collateral requirement in order to avoid the involuntary closure of the position.

The term to maturity of derivative instruments may vary from a very short time to several years. The relative change in price is often largest for instruments with a short (remaining) term to maturity. The price of a held option generally falls towards the end of the term to maturity as the time value is reduced. The client should therefore also carefully monitor the term to maturity of the derivative instruments.

Some derivative trades require that the client has to provide collateral (**margin requirement**), for example in the case of sales of options, purchases and sales of futures and forwards and swap contracts. The margin

requirement will vary depending on, among other things, the underlying securities, type of instrument and the instrument's term to maturity and volatility. The margin requirement may also vary considerably from day to day. For his own sake, the client should be ready to act immediately to provide additional collateral (to meet any higher margin requirement) or to terminate his investments in derivative contracts (close his positions) by buying or selling (opposite) contracts.

### 3.5. The risk involved in various types of derivative instruments

The main types of derivative instruments are options, forward/futures contracts and swap contracts.

#### 3.5.1. Options

An **option** is a contract which involves one party (the issuer (writer) of the option contract) undertaking to buy (Put Option) or sell (Call Option) the underlying financial instrument to the other party (the holder of the contract), at a predetermined price (the strike price), if the holder so demands. The date when the holder can exercise this right depends on the type of option in question. An **American option** may be exercised at any time during the life of the option. A **European option** may only be exercised on the expiration date. The holder pays a premium to the writer for the right stated in the contract. The price of the option normally follows the price of the underlying financial instrument. The main elements in the price of an option are the difference between the market value of the underlying financial instrument and the agreed strike price as well as a time value, which is an expression of possible future fluctuations in the value of the underlying financial instrument. The time value declines as the remaining life of the option is reduced, so that the price

of a call option may fall even if the value of the underlying financial instrument has risen.

An investor must take all such price elements into account when considering whether to close a derivative position or maintain it.

### 3.5.2. Call options

By **buying** a call option, an investor obtains a **right** to buy the underlying financial instrument on a future date at a predetermined price. When an investor buys a call option, he pays an option premium plus the costs relating to selling and administering the option contract.

The maximum amount that the holder of a call option can lose is the option premium plus the costs paid. The maximum loss arises if the price of the underlying financial instrument remains lower than or equal to the agreed strike price.

The potential gain is in theory unlimited. When exercising the option, the gain is the value of the underlying financial instrument minus the strike price and option premium including costs.

By **writing/selling** a call option, the writer incurs a **duty** to sell (if the option holder demands to buy) the underlying financial instruments on a future date and at a predetermined price. The seller of a call option receives an option premium minus the costs of selling and administering the option contract.

The potential gain on issuing/writing a call option is limited to the net option premium. If the strike price remains higher than or equal to the market price of the underlying financial instrument until the expiration

date, the holder will not normally demand to buy the securities and the writer can take the entire net option premium as profit.

The writer of a call option has an unlimited loss potential if the price rises. If the holder demands to exercise the option, the writer must buy the financial instruments in the market at the market price. The loss is calculated as the market value of the underlying financial instruments minus the strike price and option premium.

If the writer has hedged his interests by owning the underlying financial instruments (a covered call), no loss is payable if the price rises but the writer misses out on the increase in value in excess of the strike price plus net option premium. By tying up the underlying financial instruments, the writer is exposed to the risk of loss due to a fall in price and a loss arises if the fall in value is greater than the option premium. If the underlying assets are sold, the writer is subject to a risk if the price rises again. Writers of covered calls often try to manage the risk of a price fall by selling some of the underlying assets.

### 3.5.3. Put options

The **buyer** of a sell (put) option obtains a **right** to sell the underlying financial instrument at a future date at a predetermined price. The buyer of a put option pays an option premium as well as costs related to selling and administering the option contract.

The maximum amount that the holder of a put option can lose is limited to the option premium and the costs paid. The maximum loss arises when the price of the

underlying financial instrument remains higher than or equal to the strike price.

The potential for gain is limited to the strike price minus the option premium including costs. The gain is the strike price minus the value of the underlying financial instrument on the strike date and the option premium including costs.

The **writer/seller** of a put option incurs a **duty** to buy (if the holder demands to sell) the underlying financial instruments at a future date at a predetermined price. The seller of a put option receives an option premium minus costs related to selling and administering the option contract.

The potential gain on issuing/writing a put option is limited to the net option premium. If the value of the underlying financial instrument remains higher than or equal to the strike price, the holder will not normally demand to be allowed to sell the securities and the writer can take the entire net option premium as profit.

In the case of a fall in price, a loss arises when the value of the underlying financial instruments is lower than the strike price minus the net option premium. The loss is limited to the strike price minus the net option premium.

### 3.5.4. Forward/futures contracts

A **forward/futures contract** means that the parties enter into a mutually binding contract to purchase/sell the underlying financial instrument at a predetermined price, with delivery or other performance of the contract on a further agreed date.

No option premium is paid for forward/futures contracts but the agreed forward/futures price will

normally be stipulated to be the spot price (the current market price) of the underlying financial instrument plus interest costs until the forward/futures settlement date. In addition, the costs of trading and administering the forward/futures contract must be paid.

Under a forward/futures contract, the **buyer** has assumed the entire price risk relating to the underlying financial instrument. If the price falls, a loss arises which is equal to the difference between the value of the underlying financial instrument and the forward/futures price. If the price increases, a corresponding gain arises, equal to the difference between the value of the underlying financial instrument and the forward/futures price. In addition to the price risk, the buyer runs a credit risk related to the seller delivering the agreed financial instruments on the settlement date.

A **seller that owns** the underlying financial instruments runs no risk of having to pay an amount relating to developments in the price of the underlying financial instrument but loses out on the increase in value in excess of the agreed forward/futures price. The seller runs a credit risk related to the buyer being able to settle the agreed amount on the settlement date.

If the seller does not own the underlying financial instruments, he has in principle an unlimited loss potential if the price rises. The loss is calculated as the value of the underlying financial instruments minus the agreed forward/futures price. Correspondingly, in the case of a fall in price, the seller has a potential for gain which is calculated as the forward/futures price minus the value of the underlying financial instruments. The seller also runs a credit risk related to the buyer being

able to settle the agreed amount on the settlement date.

A forward/futures contract is a generic term for instruments with various calculation and settlement mechanisms but with the same risk profile. Forward/futures contracts that are to be settled by the physical delivery of the underlying financial instrument are often called forward contracts, while contracts that are to be settled by a monetary payment on the settlement date are called futures contracts.

The provision of collateral for forward/futures contracts is intended to safeguard against future fluctuations in price. Traditionally, the intermediary or settlement agent in a forward/futures contract has not provided collateral but has only demanded collateral from his clients, but the mutual provision of collateral is now increasingly being required.

In a futures contract, it is common to carry out a daily calculation based on the changes in the price since the previous stock market day in addition to providing collateral for future fluctuations.

### **3.5.5. Contracts For Difference (CFD)**

Standardized futures with individual shares or indices as underlying instruments are currently often sold as CFDs. The sellers of a CFD often require a low security collateral margin so that investors can achieve a lot of market exposure at little expense.

A Contract for Difference is highly risky. It is possible to lose more than the original investment. Prices can move quickly in the opposite direction to that expected and losses can lead to a requirement of an additional margin contribution. Under certain market conditions,

it can be difficult or impossible to close a position. This may occur, for example, when the price of an underlying instrument rises or falls so quickly that trading in the underlying instrument is restricted or closed.

The risk involved in such low margins is also that the issuer may immediately, including that same day, close the position if the value of the collateral falls below the margin requirement. The client is often given very short deadlines by which to provide more collateral and rapid fluctuations may lead to the issuer (in accordance with the contract) closing the position in contravention of the client's wishes.

The value of investments in CFDs with underlying instruments listed in foreign currencies may also vary due to changes in foreign-exchange rates.

A Contract for Difference is not suitable for all clients. The client must make sure that he fully understands the risk involved and seek independent advice if necessary.

### **3.5.6. Swap contract**

A **swap contract** means that the parties agree to make payments to each other on a regular basis, for example calculated at a fixed or floating interest rate (interest swap), or to swap an asset with each other, for example different kinds of currencies (currency swap), at a certain point in time.

### **3.6. Standardised and non-standardised derivative instruments**

Derivative instruments are traded in standardised and non-standardised forms.

Trading in **standardised** derivative instruments takes place in regulated markets and complies with

contracts and conditions which have been standardised by a stock exchange or clearing organisation

Trading in foreign standardised derivative instruments normally complies with the rules and conditions of the country in which the stock exchange trading and the clearing are organised. It is important to note that these foreign rules and conditions are not necessarily the same as those which apply in Norway.

Some investment firms offer different forms of derivative instruments which are not traded in regulated markets. These are called **non-standardised** derivative instruments (OTC derivatives). A party wishing to trade in this type of derivative instrument should examine the contracts and conditions which regulate trading in these extremely carefully.

### 3.7. Clearing

When clearing derivatives, the clearing institution becomes the counterparty between the investment firms that represent the buyer and the seller of the derivatives contracts, and guarantees that the investment firm will receive settlement for the contract. The clearing institution acts as the seller in relation to the buying investment firm and as the buyer in relation to the selling investment firm. In the standardised derivative market, derivative contracts are often cleared by a licensed central counterparty (CCP). In the OTC market, it is often the investment firm that has this role.

At present, CCPs provide no direct protection to end-investors. In both CCP-cleared trades and OTC trades, the investor runs the risk that his investment firm will not fulfil the contract.

Investors who do not want to run any risk relating to their investment firm can enter into an agreement to have a segregated account in the clearing company. Such a solution requires a separate body of agreement and leads to increased costs, and is most suitable for large institutional investors.

## 4. MUTUAL FUNDS

A Norwegian mutual (securities) fund is a "portfolio" of different financial instruments, such as shares and/or bonds. The fund is owned by all those who save in the fund, the **unit holders**, and is managed by a **management company**. There are various kinds of mutual funds with different investment strategies and risk profiles.

A unit holder receives the number of fund units that corresponds to the percentage of the fund's assets under management that the unit holder has invested.

The units may be issued (bought from) and redeemed (sold to) by the management company. The unit's actual value is normally calculated daily by the management company and is based on changes in the prices of the financial instruments in which the fund has invested. Some fund units can also be traded in a regulated market (Exchange Traded Funds ("ETF")), see item 5 below.

One of the purposes of a mutual fund is to invest in several different shares and other financial instruments. This means that unit holders run less of a risk than shareholders who only invest in one or a few shares. Unit holders do not have to select, buy, sell or monitor the shares or carry out other management work related to this.

Mutual funds are regulated by various laws and regulations.

**UCITS funds** are funds established in accordance with EU regulations and are therefore approved for marketing throughout the EEA.

**Domestic funds** are funds regulated by the Norwegian Securities Funds Act.

**Alternative Investment Funds** are fund-like investment entities that may be organised as limited companies or in other corporate forms that are not funds. These are regulated by a separate Norwegian Act relating to alternative investment funds.

For more information on mutual funds, see [www.vff.no](http://www.vff.no)

Mutual funds are also classified on the basis of the fund's investment mandate. Below is a brief description of the most common mutual funds:

**Equity fund** - a mutual fund that must normally invest at least 80 per cent of its assets under management in shares (or other equity instruments), and which must normally not invest in interest-bearing securities.

**Interest fund** - a mutual fund that is to invest in interest-bearing financial instruments. These funds are divided into bond funds and money market funds.

**Combination fund** - a mutual fund that is not defined as a pure equity fund or interest fund. A combination fund may have a more or less permanent ratio of shares to interest-bearing securities, but the percentage of various securities may also change during the fund's lifetime.

**Index fund** - a mutual fund that is managed relatively passively in relation to the fund's benchmark index.

**Fund of funds** - a mutual fund that invests its assets in one (or possibly more) underlying mutual funds.

**Specialised fund** - domestic funds that are often called hedge funds. Specialised funds are managed in a more flexible way than normal mutual funds. Specialised funds may have very different levels of risk and protection. They may entail a high level of risk-taking. Specialised/hedge funds often use investment techniques such as the extensive use of derivatives, short sales, the debt financing of investments and open currency positions. Units in specialised funds can only be offered to professional clients. This means that specialised funds cannot be marketed or sold to non-professional (retail) clients and this applies irrespective of whether the initiative is taken by the client or the investment firm. Specialised funds are under the supervision of Finanstilsynet (the Financial Supervisory Authority of Norway) and are also specially regulated by the Norwegian Securities Funds Act. Foreign hedge funds may be marketed in Norway to professional clients if Finanstilsynet grants permission for this.

## 5. EXCHANGE TRADED FUNDS AND FUND-LIKE PRODUCTS

ETP (Exchange Traded Products) is a generic term for ETF (Exchange Traded Funds) and ETN (Exchange Traded Notes). These products are traded in various trading systems, such as the Oslo Stock Exchange. They allow exposure to shares, indices, currencies, commodities and suchlike. Some of the products include a gearing element. The exposure can either be to a falling/bear market (short) or a rising/bull market

(long). There may be huge variations in the way in which these products are structured, so investors must find out a lot about the product they choose.

An ETN is normally issued by a financial institution (bank/brokerage firm) and traded in the secondary market in the same way as a share. With this type of product, the investor normally incurs a credit risk in relation to the issuer. The **credit risk** is the risk that the issuer or a counterparty will be unable to pay. This means that if the issuer does not manage to fulfil its obligations, the securities may be worthless.

ETFs are fund units issued by a mutual/securities fund. This means that, through ownership of the fund units, the investor directly owns underlying assets and thus has no credit risk in relation to the issuer.

Several ETPs contain derivative elements and/or have inbuilt gearing which can lead to the product having a high **market risk**. This means that their prices may fluctuate more than those of the underlying assets, and that the products will normally include a greater risk of loss than a direct investment in underlying assets such as shares. In addition, the geared products are rebalanced daily. This means that the return over lengthy periods will deviate from market developments when the gearing factor is taken into account. The return may be negative even if the underlying assets have the same value on the purchase and sales dates. These properties make the geared products less suitable as long-term investment alternatives.

The fact that underlying assets are often sold in other markets and listed in currencies other than NOK also means that investors must be aware of the possible foreign-exchange risk. This may mean that even if the

underlying developments indicate that the security should produce a positive return, the return may shrink, disappear or be negative as a result of exchange-rate developments.

ETPs normally have one or more liquidity guarantors (market makers) that have undertaken to provide bid and offer prices for the security. However, at times it may be difficult to execute trades in the ETP in question. This may be the case if, for example, there is little liquidity or if trading in the marketplace in question has been closed.

## 6. SHORT TRADING

"Short trading" means to sell financial instruments that one does not own. According to Norwegian law, uncovered short sales are illegal, so that anyone selling short has to borrow the financial instruments from the investment firm or in some other way ensure access to the instruments on the settlement date. At the same time, the borrower undertakes to return instruments of the same type to the lender on a predetermined later date.

Short trading is often used as an investment strategy when the financial instrument is expected to fall in value. The borrower expects to be able to buy the borrowed instruments on the later date when the instruments are to be returned, at a lower price than the price at which these instruments were sold. If the price rises instead, the borrower will incur a loss which, in the case of a sharp price rise, may be considerable.

Often, agreements to borrow financial instruments stipulate that the lender may at any time demand the return of the financial instruments by giving two-three

days' notice. This increases the risk involved in a short sale.

## **7. TRADING FREQUENCY AND COSTS**

The more frequent the trades, the higher the brokerage costs, since costs are normally incurred for each trade (purchase or sale). If the brokerage costs over time are larger than the return, this will result in a loss for the client. Please note that brokerage costs are also incurred in debt-financed trades.

Trading in securities incurs brokerage costs that normally increase in proportion to the size of the trade. If, for example, a client sells shares worth NOK 50,000 and the brokerage rate is 0.2%, the sale costs NOK 100. If, on the other hand, shares are sold for NOK 500,000, the brokerage cost will be NOK 1,000. In addition, minimum brokerage fees are used, so that the sale or purchase of securities for a small amount may be percentagewise more expensive than selling/buying for a larger amount.

## **8. LEVERAGED (DEBT-FINANCED) TRADING**

Financial instruments can in many cases be bought for partially borrowed capital. Since both the capital invested by the client and the borrowed capital affect the return, the client may make a larger gain through debt financing if the investment develops positively compared to an investment made using only the client's own capital. The debt linked to the borrowed capital is not affected by any rise or fall in the prices of the purchased instruments, which is an advantage if prices rise. However, if the price of the purchased instruments falls, this results in a corresponding disadvantage since the debt remains the same. In the case of a price drop, therefore, the client's own invested capital may be entirely or partly lost while the debt has

to be repaid in whole or in part from the revenues from the sale of the financial instruments that have fallen in value. The debt must also be repaid even if the sales revenues do not cover the entire debt.

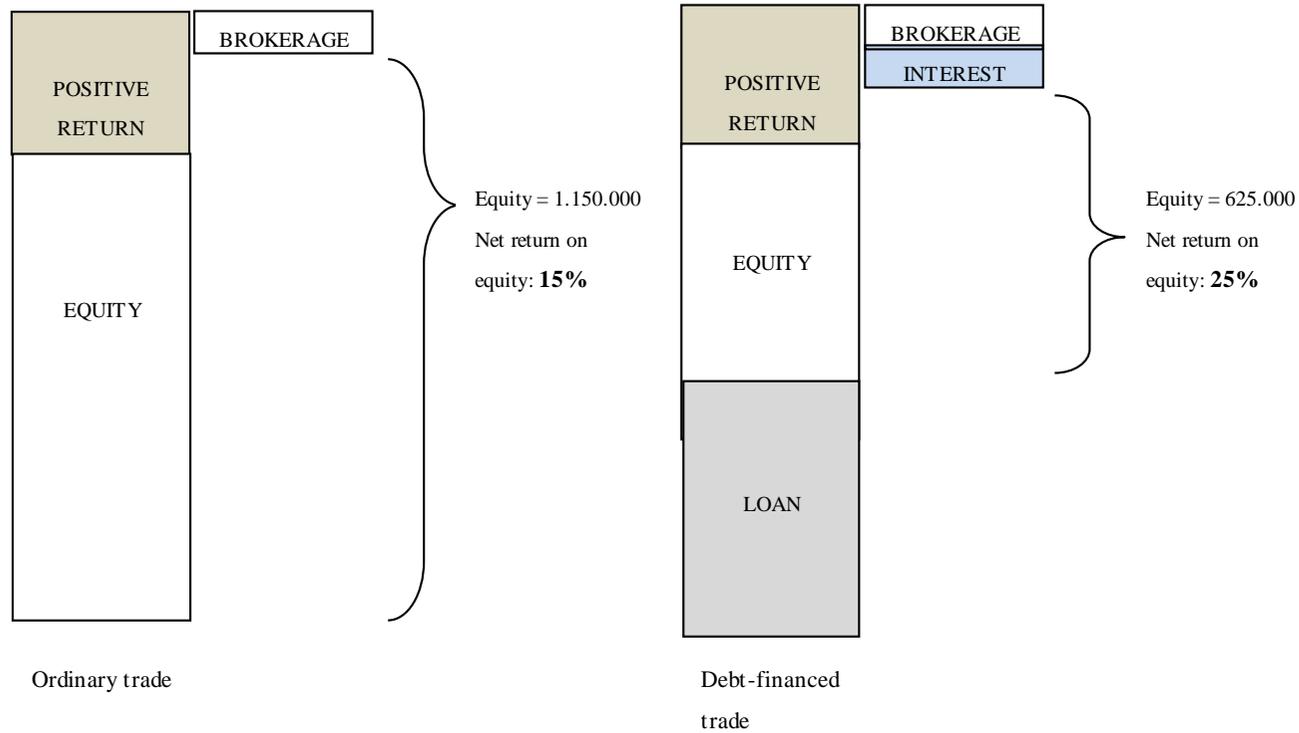
The risk entailed in a debt-financed share purchase increases with the level of debt financing. For example, a portfolio which is 80% debt-financed will lose all its equity if share prices fall by 20%. If the portfolio is 60% debt-financed, the equity will be lost if share prices fall by 40%.

The return on equity in a partially debt-financed portfolio will fluctuate more than in a corresponding equity-financed portfolio and the debt financing will only produce an additional return when the return on the investment is higher than the borrowing rate.

An illustration of a positive return in the case of partial debt financing is provided below.

Assumptions:

- 20% positive return
- NOK 1.000.000 invested in the market
- 5% brokerage fee (20 transactions with a brokerage fee of 0,25%)
- 5% interest expense
- 50% debt financing



An illustration of a negative return in the case of partial debt financing is provided below.

Assumptions:

- As above, but a 20% negative return

