Swiss Banking

Risks Involved in Trading Financial Instruments

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Note
Risks are highlighted in a light blue box:

Country risk
The value of a financial instrument and thus the possibility of accessing it ...

About this brochure

Dear Readers
The Financial Services Act (FinSA), in force since 1 January 2020, contains code of conduct provisions with which financial service providers must comply vis-à-vis their clients. It defines the requirements for providing financial services in an honest, diligent and transparent manner and sets out how financial instruments are to be produced and offered. It also makes provision for prospectus duties and requires an easily understandable key information document about the general risks associated with financial instruments.

This brochure is intended to help you make sound investment decisions and compare the various financial instruments.

About the content
The first part of the brochure contains general information on typical financial services for investment solutions and the risks attached to the trading, buying, selling and custody of financial instruments. The second part outlines the characteristics and risks of the different types of financial instrument. The third part contains further information on specific financial instruments. Last but not least, we have compiled a glossary of key terms for you at the end of the brochure.

Further information
This brochure can neither cover all available financial instruments nor provide an exhaustive account of all the opportunities and risks they entail. If your financial service provider offers the respective key information document on a particular financial instrument, it will contain detailed information on the risks and costs involved. Furthermore, this brochure does not take account of clients' individual situations and only briefly touches on the tax and legal implications of investments. For comprehensive personal advice on your financial situation, please consult your financial service provider and, if necessary, a tax or legal expert.

We hope that you find this brochure both useful and interesting to read. If you have any suggestions or feedback, you can send an e-mail to office@sba.ch.

Yours,
Swiss Bankers Association (SBA)

Chapter 1.6 has been added to this updated June 2023 edition.

1 General information

1.1 Explanation of terms

This section introduces the key terms relating to the risks involved in trading financial instruments. An extensive Glossary containing further definitions can be found at the end of the brochure.

What is a financial instrument?
The Financial Services Act (FinSA), in force since 1 January 2020, defines the following as financial instruments:

1. Equity securities
   a) Securities in the form of shares, including share-like securities allowing for participation or voting rights, such as participation or dividend rights certificates.
   b) Securities that, on conversion or execution of the rights embedded in them, allow for the acquisition of equity securities as soon as they are registered for conversion.

2. Debt instruments: securities that are not equity securities.

3. Units of collective investment schemes in accordance with the Collective Investment Schemes Act of 23 June 2006 (CISA).

4. Structured products, i.e. capital-protected products, capped return products and certificates.

5. Derivatives in accordance with the Financial Market Infrastructure Act of 19 June 2015 (FMIA).

6. Deposits with a redemption value or interest that depends on risks or prices, excluding those with interest linked to an interest rate index.

7. Bonds: shares of an overall loan subject to uniform conditions.

Physical and book-entry securities

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

These days, most financial instruments no longer exist in physical form. They are known as book-entry securities – also referred to as uncertificated securities in the Federal Act on Intermediated Securities of 3 October 2008. Bookentry securities, including shares (see section 2.1), bonds (see section 2.2) and collective investment schemes (see section 2.4), are so called because they are simply booked to a custody account.

Who is an issuer, and what is an issue?
The word "issue" is used when a new security is offered for trading. Anyone who offers or intends to offer securities for trading is thus an issuer.

Who is a financial service provider?
A financial service provider is anyone who provides financial services on a professional basis (i.e. as a permanent, independent and commercial activity) in Switzerland or for clients in Switzerland. Banks and other financial institutions also qualify as financial service providers.

What are typical financial services?
Various forms of financial services are offered for investment solutions: portfolio management, investment advice and execution-only (with no advice). With portfolio management, investment decisions are delegated to the financial service provider. With investment advice and execution-only services, the client retains full responsibility for investment decisions. The financial service provider's duties thus differ, particularly as regards informing the client.

What is the difference between direct and indirect investments?
Direct investments involve investing in actual assets – such as shares, bonds, real estate, precious metals or commodities – directly. Indirect investments involve investing in assets indirectly via an investment vehicle, for example a fund or structured product.

Direct and indirect investments can be used for different purposes. Funds for instance, focus on risk diversification, whereas structured products with participation or leverage (see section 2.7 and section 3.4.3) strive to maximise returns. Other investments offer the opportunity to invest in an otherwise inaccessible asset class, commodity certificates being a good example.

Whether an investment is direct or indirect has no bearing on its risks or returns. When deciding to invest indirectly, for example in alternative investments (see Glossary), it is important to consider not only the risk associated with the asset class, but also the risks attached to the financial instruments contained in the investment vehicle. This is especially true for structured products. Direct alternative investments generally require a relatively high minimum investment and are often not available to all investors.

What are limited and unlimited risks?
Financial instruments with limited risk entail the risk of making no profit and possibly losing all of the invested capital in a worst-case scenario. With unlimited-risk instruments, the investors may even have to pay out more money on top of what they originally invested, perhaps several times as much.

1.2 Typical financial services

According to FinSA, typical financial services for investment solutions include portfolio management, investment advice and execution-only transactions with no advice.

Investment advice
Investment advice consists of personal recommendations that relate to the trading of financial instruments. It can be either portfolio-based (geared to the client's portfolio and defined investment strategy) or transaction-based (focused on individual financial instruments).

Only banks or other financial institutions with the requisite licence or persons entered in the Register of Advisers may provide investment advice on a professional basis.

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

Portfolio management
With portfolio management, the client entrusts assets to the financial service provider and instructs the latter to invest them on their behalf in accordance with a contractual agreement that sets out the client's investment goals. Investment decisions are made exclusively by the financial service provider. Portfolio management agreements can differ from one provider to another, but they always involve the delegation of the management of assets.

Since the financial service provider is responsible for investment decisions, it is not obliged to supply key information documents for the financial instruments used.

Execution-only
With execution-only services, clients make their own investments without receiving any advice or recommendations from the financial service provider. The client thus bears full responsibility for assessing investment instruments and the risks they entail.

However, for certain categories of financial instruments, e.g. collective investment schemes and structured products, the financial service provider must supply the client with a key information document, if one is available, before executing execution- only transactions.

Loans for trading in financial instruments

Conventional lending, including mortgages, is subject to civil-law provisions under the Swiss Civil Code (SCC) and the Code of Obligations (CO). However, when a client takes out a loan in order to invest in financial instruments, for instance in the form of a Lombard loan, this financial service is subject to FinSA. Due to the specific risks associated with this type of lending, the FinSA provisions on investor protection apply in full (see section 1.3 “Risks involved in credit-financed investments”).

1.3 General risks in trading financial instruments

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

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

Country risks concern the political and economic stability of a given country. Examples of political risks include the potential confiscation of assets and state intervention in certain industries. Economic risks typically include fluctuations in interest and inflation rates. Other country risks concern the quality of infrastructure (particularly as regards clearing houses and exchanges) and the legislative framework: market transparency, supervisory authorities, investor protection, insolvency regimes and taxation.

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

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

Investments in emerging markets entail risks that are less pronounced or entirely absent in developed countries, including settlement (see Settlement risk) and liquidity risks (see Liquidity risk). Higher risks associated with investments in financial instruments relating to emerging markets also apply when the issuer (see section 1.1) or offeror only has its head office or the focus of its activity in such a market.

Issuer risk
Most investments involve a risk that the issuer (see Glossary) will become insolvent. This is called the issuer risk. A financial instrument’s value depends not only on product-specific aspects – e.g. business results for equities or the performance of the underlying financial instrument for structured products – but also on the issuer’s creditworthiness. This can change at any time during the term of an investment.

It is therefore important to know who issued the instrument in question and who is responsible for meeting the obligations. This is essential for correctly assessing the issuer's creditworthiness and thus the issuer risk. With debt instruments (see Glossary) such as bonds, this risk is known as the credit risk because the borrower normally acts as the issuer.

Settlement risk

A settlement risk arises when a financial instrument must be bought at a specific price before delivery. In this case, the investor risks paying the purchase price without receiving the instrument on time or even at all. Conversely, an investor who sells a financial instrument and must deliver it without receiving the purchase price also incurs a settlement risk. Settlement risks are especially high in emerging markets and for some offshore funds, private equity investments and derivatives (see Glossary).

Currency risk

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

Liquidity risk

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

Legal risk

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

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

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

Interest rate risk
Interest rate risk affects investors buying bonds, particularly when interest rates rise as this means that new bonds will be issued with higher rates, making existing bonds with lower rates less attractive and causing their prices to fall.

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

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

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

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

Cluster risks at issuer (see Glossary) country and sector level must be taken into consideration. A cluster risk at issuer level exists, for example, in a portfolio containing a bond issued by Company X, shares in Company X, a structured product with Company X as its underlying asset (see Glossary) and an equity fund with 20 % of its assets invested in that same Company X.

Structuring risk

Investments can be either direct or indirect (see section 1.1). Indirect investments are made through an investment vehicle, which may be a collective investment scheme (such as a fund), a structured product or an option. The way this vehicle is structured can affect the investment's risk profile and might even create new risks.

Risks involved in credit-financed investments

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

- Leverage effect

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

- Margin requirements and liquidity squeezes

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

- Currency risk

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

1.4 Risks attached to buying, selling and custody – particularly abroad

Custody chain

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

Fig. 1

Simplified illustration of a custody chain



Source: Swiss Bankers Association (SBA)

Third parties are often involved in derivatives transactions as well. Exchange-traded derivatives are either traded directly on an exchange or via brokers (see Glossary). Both exchange-traded and over-the-counter (OTC) derivatives (see section 3.3.1) must be reported to a trade repository (see Glossary).

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

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

Collective custody

Banks generally entrust financial instruments to a third-party custodian in their own name. With collective custody, however, several investors' financial instruments are held collectively by the third-party custodian, i.e. they are not held separately for each individual investor. A bank is liable for its own actions, as well as for any loss or damage caused by the third-party custodians it uses, under the applicable legal provisions, in particular those of the Swiss Code of Obligations, the Federal Act on Intermediated Securities and any contractual agreements.

Insolvency

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

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

Disclosure obligations

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

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

Information on disclosure

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

Banks are expressly authorised to transmit non-public information to certain foreign entities by Article 42c of the Financial Market Supervision Act (FINMASA). The Swiss Financial Market Supervisory

Authority FINMA has published a circular on this topic as part of its supervisory practice (Circular 2017 / 6 "Direct transmission"). For this purpose, banks obtain their clients' consent to bypass certain confidentiality requirements, for example under banking secrecy or the Federal Act on Data Protection. They normally do so by including this in their general terms and conditions, terms and conditions of custody etc. or in the form of a written waiver.

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

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

1.5 Tax treatment of financial instruments

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

Foreign investments entail a risk of double taxation for countries that have not signed a double taxation treaty with the investor's country of domicile. Foreign countries may additionally levy withholding taxes that cannot be reclaimed in Switzerland.

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

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

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

1.6 Sustainability-related financial risks (ESG-risks)

ESG stands for **environmental** (e.g. energy and water consumption), **social** (e.g. employer appeal and supply chain management) and **governance** (e.g. remuneration policy and company management).

ESG-risks are events or situations in these three areas that are **currently having a negative impact on economic, cost or reputation factors, for example, and thus also on the value of a company or the market price of financial instruments or could potentially do so in future.**

Environmental risks are commonly divided into two categories: physical risks and transition risks. Physical risks include, for example, damage and costs arising from extreme weather events caused by climate change, such as storms, flooding and heatwaves, which threaten or harm a company's economic activities or assets. Transition risks include regulatory risks, changes in consumer behaviour and liability or legal risks. One example of a transition risk would be the introduction of a tax on carbon dioxide emissions, which could negatively affect a company's profitability and thus its enterprise value.

Social risks can arise, for example, from violations of employment standards, a lack of attention to occupational health and safety, poor product safety, failure to address social issues, unfair treatment of staff or high staff turnover.

Governance risks, meanwhile, can arise from unequal treatment of shareholders, inadequate risk management or control mechanisms, inappropriate remuneration systems or rule violations (e.g. corruption), among other things.

ESG-risks can affect specific asset classes, regions, economic sectors and/or companies in different ways. For instance, climate change, environmental destruction and the need to adopt more sustainable business practices can lead to changes in the real economy that might create new risk factors for investors. Investors, therefore, should always incorporate ESG-risks into their risk diversification decisions.

ESG-risks and characteristics can be integrated into asset management and investment advisory processes using a range of different ESG-approaches, all of which are evolving rapidly. It is important for investors to understand that these approaches have different aims and that not all of them are geared to a measurable positive impact on ESG-factors such as reducing pollution.

2 Financial instruments and their specific risks

This second part provides an overview of the characteristics and specific risks of the main types of financial instruments. More detailed explanations of individual financial instruments can be found in the third and final part of this brochure.

2.1 Equity securities (shares, participation certificates and dividend rights certificates)

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

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

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

2.2 Bonds

What are bonds?
From the issuer's perspective, bonds are a form of fixed-term borrowing. The issuer (borrower) normally pays a fixed rate of interest at regular intervals. Most bonds are redeemed at the end of their term, and some can be redeemed early. In addition to conventional bonds, there are special forms that, alongside their debt function, also have equity-like features from the issuing company's point of view. These include convertible, warrant and hybrid bonds (see section 3.1.2).

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

Bonds are subject to market, issuer, liquidity, interest rate and currency risks (see section 1.3). Holders of a bond can lose some or all of their investment if the issuer goes bankrupt as bonds are not classed as privileged claims – in fact, they are allocated to the third bankruptcy class (see Glossary).

More detailed information on bonds can be found in section 3.1.

2.3 Money market products

What are money market products?
Money market products are debt instruments (see Glossary) issued as certificated or uncertificated securities (see section 2.2) for short-term financing purposes. They have terms of up to one year. The purchase or sale price is the nominal or face value minus the total interest accruing over the term.

What risks are associated with money market products?
The value of a money market product can fall during its term. Since the issuer is often a government, the issuer risk (see section 1.3) is usually lower than for other fixed-income investments (see Glossary). However, there may be currency risks.

2.4 Collective investment schemes

What are collective investment schemes?
Collective investment schemes are pools of assets supplied by investors to be jointly invested on their account. They make broadly diversified investments possible with a small amount of invested capital.

Collective investment schemes come in many different forms and are extensively regulated in Switzerland. In particular, they are subject to approval and supervision by the Swiss Financial Market Supervisory Authority FINMA. The main form of collective investment scheme is the contractual investment fund. Investors in Switzerland can choose from a wide range of foreign funds in addition to Swiss-domiciled ones. Collective investment schemes may adopt various strategies: money market, equities, bonds, asset allocation, real estate, commodities or alternative investments. The legal documents constituting a fund – the fund regulations, articles of association or fund contract – describe the investments it can make.

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

The legal documents constituting a fund, as well as its prospectus and (where applicable) key information document, describe its risk profile in detail.

More detailed information on collective investment schemes can be found in section 3.2.

2.5 Options

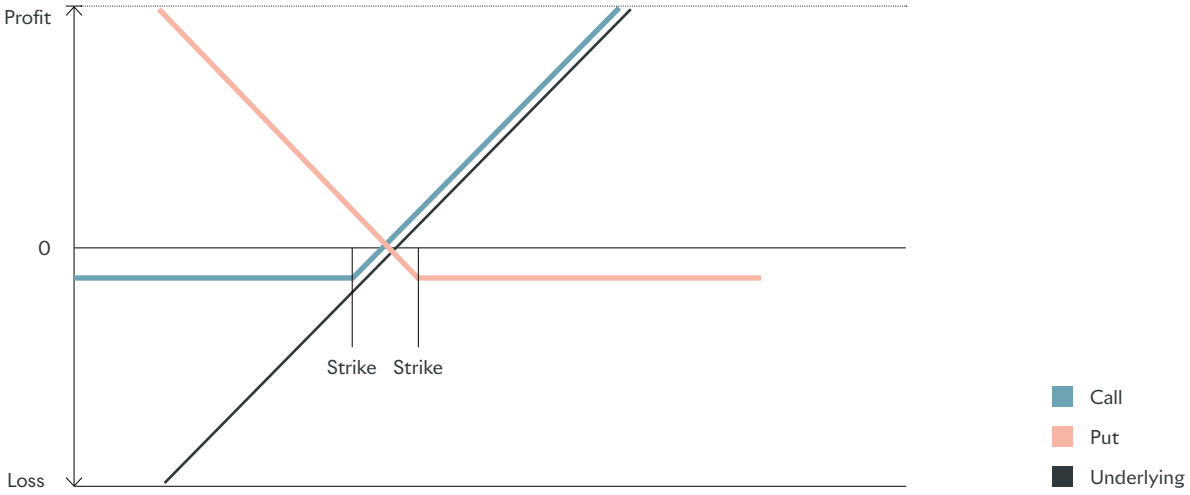
What are options?

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

- Investment assets: e.g. shares, bonds, precious metals
- Other instruments: currencies, interest rates, indices
- Events: credit events, natural disasters

Fig. 2

Example of a buyer

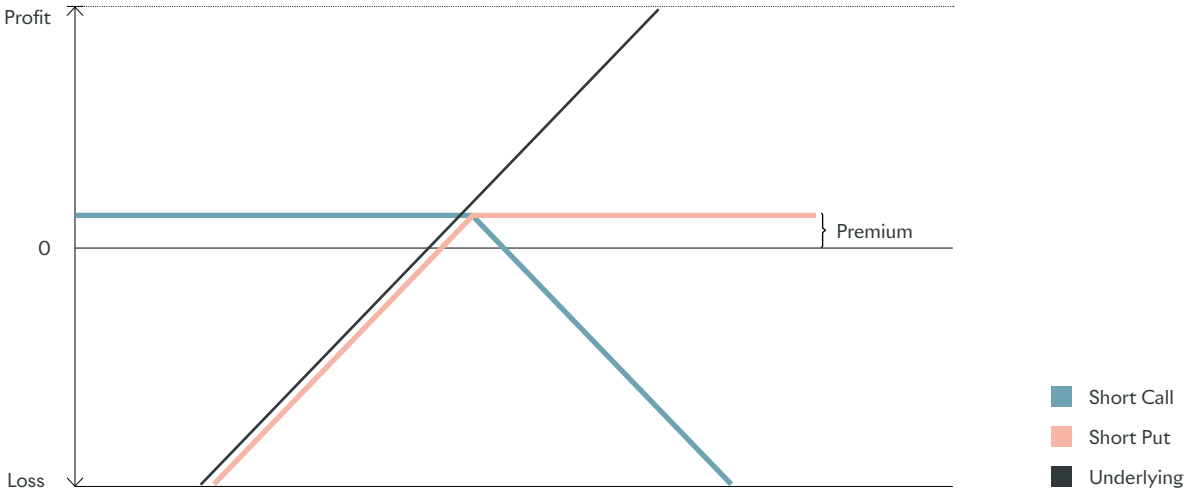


The buyer of an option has the right to buy a specified amount of an underlying from the seller (call option) or sell it to the seller (put option) at a predefined price (known as the strike price) on or before a set point in time (the expiry date). The price of this right is called the premium.

Source: SBA

Fig. 3

Example of a seller



The seller (writer) of an option must sell the underlying to the buyer at the strike price (short call) or buy the underlying from the buyer at the strike price (short put) on or before the expiry date, irrespective of the current market value of the underlying, if the buyer chooses to exercise the option. The buyer pays the seller a premium in exchange for this right.

Source: SBA

What risks are associated with options?

Different types of options are subject to different risks. A call option is said to be "in the money" when the current market value of the underlying is above the strike price. A put option is in the money if the current market value is below the strike price. Generally speaking, if the market value of the underlying falls, so does the value of a call option. The value of a put option, meanwhile, tends to fall if the market value of the underlying rises. Normally, the less an option is in the money, the larger the fall in the option's value. In such cases, the value normally falls much more sharply close to the expiry date.

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

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

More detailed information on options can be found in section 3.3.

2.6 Structured products

What are structured products?
Structured products are issued either publicly or privately. Their redemption value depends on the performance of one or more underlying assets, e.g. shares, interest rates, currencies or commodities. They may have a fixed or unlimited term and consist of one or more components. They may also be admitted to trading on an exchange.

The Swiss Structured Products Association (SSPA) categorises structured products into the following main groups:

- capital protection (see section 3.4.1)
- yield enhancement (see section 3.4.2)
- participation (see section 3.4.3)
- investment products with reference entities (see section 3.4.4)

What risks are associated with structured products?
Structured products bear the risk that the issuer may become insolvent (issuer risk). Their value thus depends not only on the performance of the underlying, but also on the creditworthiness of the issuer, guarantor or reference entity. This can change at any time during a structured product's term.

It is also important to consider a structured product's specific risk profile, which can either reduce or increase the risks associated with individual underlyings. Depending on the type of structured product, therefore, investors may aim to profit from rising, stable or falling prices. It is imperative that investors inform themselves precisely about the specific risks attached to a structured product before buying it. This information can be found in the product documentation, the key information document or the prospectus.

More detailed information on structured products can be found in section 3.4. and on the SSPA website at www.sspa.ch.

2.7 Leverage products

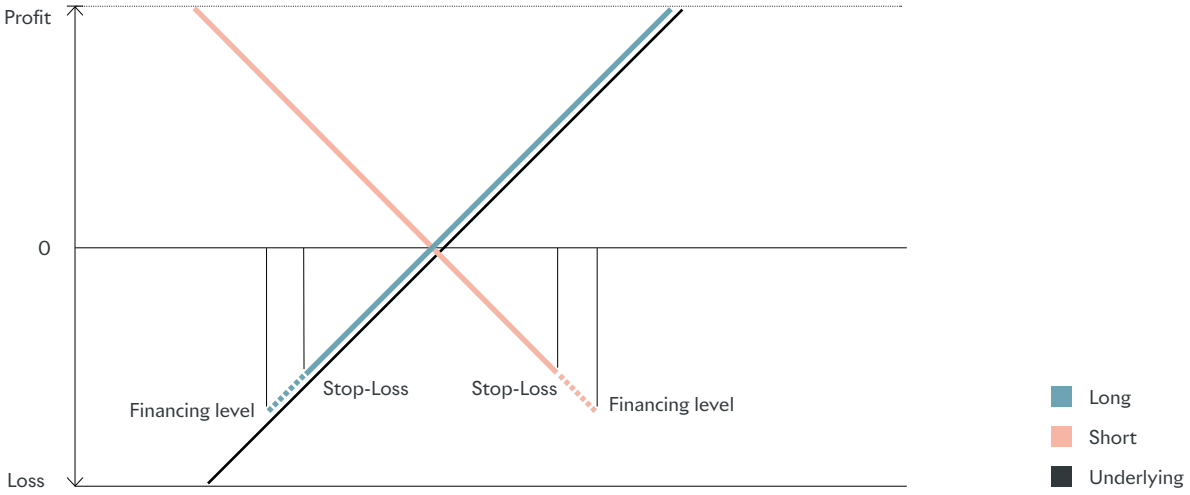
What are leverage products?
Leverage products are normally regarded as a category of structured products, but this brochure treats them as a separate product class because they differ significantly from other types of structured products. Whereas structured products are usually a combination of a conventional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

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

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

Fig. 4

Example: Mini-Future

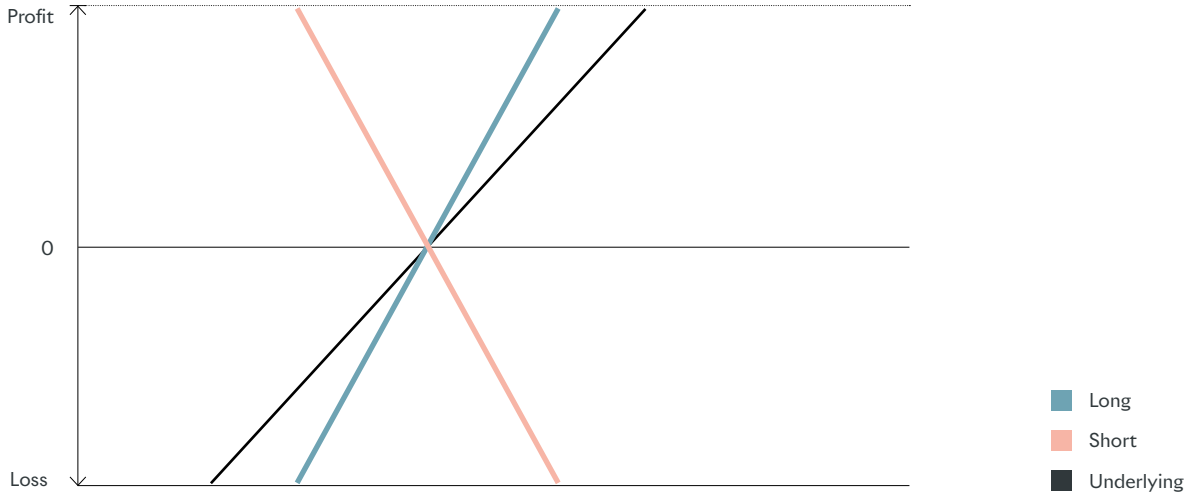


With a mini-future, investors participate in the price of the underlying on a leveraged basis with a small amount of invested capital, provided the price remains above a stop-loss level.

Source: Swiss Structured Products Association (SSPA)

Fig. 5

Example: Constant Leverage certificate



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

Source: SSPA

What risks are associated with leverage products?
Because of the leverage effect, the underlying must be monitored regularly and carefully, since leverage products can experience not only disproportionately large gains, but also disproportionately large losses compared with the underlying.

In the worst-case scenario, all of the capital invested in a leverage product may be lost.

2.8 Futures and forwards

What are futures and forwards?
Futures and forwards are agreements whereby a buyer and a seller undertake to buy or sell a specific underlying at a predefined price at a specific point in time (the expiry date). The obligation applies regardless of the current market value on the expiry date.

- Futures are standardised contracts in terms of the quantity of the underlying and the expiry date that are traded on an exchange. Some futures can give rise to a delivery obligation even before the expiry date.
- Forwards, meanwhile, are not traded on an exchange. They can be either standardised or individually agreed between the buyer and seller.

What risks are associated with futures and forwards?
Futures and forwards can involve special risks. Only investors who are familiar with these financial instruments, have sufficient money available and are able to bear potential losses should invest in them.

With forward sales, the underlying must be delivered at the price originally agreed on if its market value has since risen above the agreed price. The loss risk is thus equal to the difference between the two prices. Since there is theoretically no limit to how far the market value of the underlying can rise, the potential loss is also unlimited.

The forward sale of an underlying the seller does not own at the time the contract is signed is known as a short sale. It entails a risk in that the seller may have to buy the underlying at a price higher than the agreed price in order to meet the delivery obligation on expiry.

Conversely, with forward purchases, the buyer must take delivery of the underlying at the price originally agreed even if its market value has since fallen below the agreed price. The loss risk is thus equal to the difference between the two prices. The maximum loss therefore corresponds to the originally agreed price.

In order to limit price fluctuations, an exchange may set price limits for certain contracts. Investors should inform themselves of such limits before investing in futures as it can be much more difficult or even impossible to close out a contract if a price limit is reached.

The market for standardised forwards is transparent and often also liquid, so contracts can normally be closed out without difficulty. There is no actual market for forwards agreed on individually, so they may only be closed out with the counterparty's (see Glossary) consent. Contracts featuring a combination of different elements can entail significantly different risks, in particular if not all of the elements can be closed out. Investors should thus consult their securities dealer (see Glossary) for detailed information on the special risks before entering into such contracts.

More detailed information on futures and forwards can be found in section 3.5.

2.9 Financial instruments for financing or risk transfer purposes (credit and catastrophe derivatives)

What are financial instruments for financing or risk transfer purposes (credit and catastrophe derivatives)?
Some financial instruments are used mainly to transfer risks. These include credit and catastrophe derivatives, for which the underlying is an event such as a credit event (default on a loan or bond) or a natural disaster. Credit derivatives come in the form of swaps, options or hybrid financial instruments (see Glossary).

What risks are associated with financial instruments for financing or risk transfer purposes?
Credit and catastrophe derivatives are subject to liquidity risks because a lack of trading may make it impossible to sell them before expiry.

The risks in a credit portfolio can be securitised and transferred to third parties (see Glossary > Asset-backed security) in the form of credit-linked notes, collateralised debt obligations or asset-backed securities.

Further information on credit derivatives can be found in section 3.1.3.

2.10 Offshore funds and hedge funds

What are offshore funds and hedge funds?
Offshore funds and hedge funds are collective investment schemes that are subject to no or only partial regulation and supervision. Hedge funds are free to choose the asset classes, markets – including high-risk countries – and trading methods they employ. They often have aggressive strategies and work with investment techniques that decouple investment performance from the performance of the underlying markets.

What risks are associated with offshore funds and hedge funds?
Managers of offshore funds and hedge funds often enjoy maximum flexibility in their investment decisions and are normally not bound by the rules on liquidity, redemption, avoiding conflicts of interest, fair pricing, disclosure and use of leverage that apply to conventional funds. They also have limited liquidity.

More detailed information on offshore funds and hedge funds can be found in section 3.6.

2.11 Private Equity

What is private equity?
Private equity is a form of investment to provide risk capital financing for companies that either are not listed on a stock exchange or (in exceptional cases) wish to delist. Investments are usually made at an early stage in a company's development, when its chances of success are uncertain and the risks are therefore high.

What risks are associated with private equity?
Private equity investments are not usually subject to regulation, in particular with regard to investor protection. Because of this and their lack of transparency (e.g. limited disclosure of financial accounts or no publication), they entail higher risks for investors. This is especially true for private equity vehicles domiciled in countries with comparatively relaxed legislation.

Private equity investments involve considerable risks and can lead to substantial losses, including total losses. They are also geared to the long term and often have highly limited liquidity.

More detailed information on private equity can be found in section 3.7.

2.12 Real Estate

What are real estate investments?
Investments in real estate can be made directly or indirectly. Real estate comprises office buildings, retail and industrial premises, residential property and special real estate (such as hotels or hospitals). The variables that determine the value of a property are its location and facilities and the variety of ways in which it can be used. Direct investments involve buying properties directly rather than investing via a securities dealer (see Glossary).

Indirect investments generally require a lower capital outlay than direct investments and can be listed on an exchange or unlisted. Examples of unlisted indirect investments include real estate funds (see section 3.2.3), shares of real estate companies that are not traded on an exchange and certificates on real estate funds. Real estate funds can reduce risks by diversifying across geographical areas and real estate categories. Listed indirect investments include real estate investment trusts (REITs), which make it possible to invest in real estate without incurring certain disadvantages, such as illiquidity.

What risks are associated with real estate investments?
Anyone investing indirectly in real estate must consider the risks attached to the financial instrument in question. There are traditional, strictly regulated funds that invest in real estate, but indirect real estate investments can also have similar characteristics to hedge funds or private equity and thus entail higher risks. Ultimately, physical assets – buildings and land – underlie all real estate investments. Each of these assets is unique, so there is no regulated trading.

Property markets are also frequently intransparent and require precise knowledge of local circumstances. It is thus essential to involve local experts, which makes market access more difficult.

Real estate sometimes reacts to interest rate changes in a similar way to bonds: when interest rates are low, for instance, mortgages are cheap, and it is easy to generate above-average returns. Conversely, high interest rates depress returns. Government tax incentives intended to promote home ownership and attractive lending conditions can also lead to excessively high prices.

2.13 Precious metals

What are precious metals?
The most common precious metals are gold, silver, platinum and palladium. It is possible to invest in them either directly – by buying the physical metal or opening a precious metals account – or indirectly (see section 1.1) – by buying fund units, derivatives or structured products linked to the price of a precious metal. When investing directly in physical metals, investors can choose from different units of weight and levels of purity. Gold is normally present on European markets in the form of non-exchangeable, numbered bars (or ingots) weighing 12.5 kg each with a purity of 99.5 – 99.99 % and exchangeable bars weighing 25 g, 500 g or 1 kg with 99.99 % purity.

Coins such as the South African Krugerrand and the Canadian Gold Maple Leaf are another means of investing in precious metals. On European markets, silver is normally traded in the form of numbered bars or ingots weighing around 30 kg or 1 kg, while platinum is traded as 1 kg or one-ounce bars and palladium as 1 kg bars.

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

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

If, on the other hand, an investor opts to open a precious metals account with a bank, the investor does not have ownership rights but merely a claim to delivery of the physical metal. This means that the investor is exposed to the risk of default by the bank, for example if it goes bankrupt. Precious metals accounts are comparable to currency accounts, but they are denominated in the metal concerned (e.g. XAU for gold) rather than a currency.

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

2.14 Commodities

What are commodity investments?
Commodities are physical goods that are produced via agriculture and mining, for example, and standardised for use as the underlying of a transaction. Derivatives on commodities such as energy sources (e.g. oil and coal), metals and agricultural produce are traded primarily on futures markets.

Investors can contract to buy or sell futures linked to the performance of a particular commodity, for instance in order to buy a standardised quantity of the commodity at a specific future time for a predefined price.

A common way for private individuals to invest indirectly in commodities is via structured products (see section 2.6). Other ways to invest in commodities are commodity funds (see section 3.2.3) and financial instruments that are not admitted to trading on an exchange such as over-the-counter swaps and options. These are tailor-made products traded directly between a buyer and a seller. More detailed information on how forwards and futures work can be found in section 3.5.

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

What risks are associated with commodity investments?

The price of commodities is influenced by various factors, including the following:

- the relationship between supply and demand
- climate and natural disasters
- state programmes and regulations, national and international events
- state intervention, embargoes and tariffs
- movements in interest and exchange rates
- trading in commodities and the corresponding contracts
- provisions relating to monetary policy as well as trading, fiscal and currency controls
- additional investment risks arising out of the combination of these variables

Commodity investments are more volatile than conventional investments, and their returns can often fall suddenly and sharply. The volatility of a commodity's price also affects the value and hence the price of futures and forwards it underlies. For example, conventional oil futures are normally easy to trade, regardless of their term, but they can become illiquid if market activity is low. This can cause their prices to fluctuate significantly, which is a typical feature of commodities.

2.15 Investments in cryptocurrencies and tokens

What are investments in cryptocurrencies and tokens?

In an initial coin offering (ICO), investors transfer financial assets to the ICO organiser, usually in the form of cryptocurrencies. In return, they receive blockchain- based "coins" or "tokens". These are created and stored in a distributed system using a specially developed blockchain or smart contracts (see Glossary) on an existing blockchain (see FINMA Guidance 04 / 2017). The tokens issued can have different functions. They can serve as a simple means of payment (cryptocurrency) or confer the right to use a service or a right of ownership in relation to the ICO organiser.

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

Tokens that confer ownership rights qualify as securities (see Glossary) and are thus subject to the applicable laws, including the Anti-Money Laundering Act (AMLA) and the Financial Market Infrastructure Act (FMIA).

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

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

Investors who are interested in this type of investment opportunity are advised to study technical and regulatory developments in the field carefully and in particular to consult the relevant publications from the Swiss Financial Market Supervisory Authority FINMA.

3 Detailed explanations of individual financial instruments

This section complements the information in the first two sections with more detailed explanations and illustrations of selected financial instruments.

3.1 Bonds

3.1.1 Convertible and warrant bonds

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

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

3.1.2 Hybrid bonds

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

Special risks
The overview below is limited to the characteristic features and risks of the most commonly issued types of hybrid bond. Investors are advised to consult the term sheet or key information document before making a decision.

Examples of hybrid bonds

Issuers: banks

Additional Tier 1 bonds

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

Since their mandatory conversion is contingent on a particular condition, Additional Tier 1 bonds are also known as contingent convertibles or CoCos (see section 3.1.1).

Tier 2 bonds

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

Bail-in bonds / gone-concern capital

Bail-in bonds are issued as loss-bearing debt instruments in the event of insolvency measures. They are intended to ensure that a systemically important bank that has collapsed can make an orderly exit from the market and that systemically important services can be maintained. When a failed bank is

restructured or wound up, bail-in bonds can be converted to equity or their nominal value reduced. In order to make them clearly distinct from conventional bonds, which have "preferred senior" or "senior unsecured" rank, bail-in bonds must be given a lower rank either structurally – by being issued (see Glossary) by a non-operating group holding company – or contractually. A new rank, "non-preferred senior", has therefore been created for them.

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

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

Issuers: industrial companies
Industrial companies issue hybrid bonds to strengthen their capital ratios and / or improve their ratings. As a rule, the bonds have a lower rank, an unlimited term and an option for the issuer to repay them. Bonds that are not repaid have their interest rate reset at predetermined times, usually with a margin relative to the original credit spread. Coupon payments may be suspended.

In addition to the usual repayment arrangements, industrial companies can normally repay their hybrid bonds at any time at face value if certain factors (such as their financial reporting, rating or tax burden) undergo negative changes.

3.1.3 Asset-backed securities (ABSs)

With asset-backed securities (ABSs), risks, for instance those attached to a group of debt claims, are transferred to a special-purpose vehicle (SPV). The SPV finances this transaction by issuing bonds backed by a portfolio or a pool of assets, hence the term "asset-backed". If the assets backing a bond are mortgages, it is called a mortgage-backed security (MBS). Many other types of ABS exist, and there is no standard structure or terminology. Two examples are collateralised debt obligations (CDOs) and collateralised loan obligations (CLOs). The individual portfolio components would be unattractive or even unobtainable in this form for individual investors. Creating a portfolio makes it possible to combine and sell a range of assets and risks.

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

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

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

3.2 Collective investment schemes

3.2.1 Swiss collective investment schemes

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

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

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

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

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

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

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

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

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

3.2.2 Foreign collective investment schemes

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

3.2.3 Investment strategies of collective investment schemes

The investment opportunities open to collective investment schemes vary according to their legal form and category. The investment strategy set out in a collective investment scheme's legal documentation (fund regulations or articles of association, depending on the legal form) defines the investments it can

make. Collective investment schemes' strategies are geared first and foremost to risk diversification. Below are some examples of possible investment strategies.

Examples of investment strategies

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

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

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

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

Real estate funds
Real estate funds typically buy investment properties such as apartment blocks or commercial premises. They offer diversification benefits thanks to their low correlation (see Glossary) to bonds and shares. The downside is poor liquidity, which may limit the scope for redeeming units of real estate funds. For more information on real estate investments, see section 2.12.

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

who are prepared to accept large price fluctuations. For more information on commodity investments, see section 2.14 and section 3.6.

Liquid alternatives
Liquid alternatives are regulated investment funds with alternative investment strategies that differ from those of traditional funds but still meet the requirements of the EU's UCITS Directive. These strategies are more like those of offshore funds and hedge funds and use a variety of investment instruments. For more information on offshore funds and hedge funds, see section 2.10. Liquid alternatives are more strictly regulated, more transparent and more liquid than offshore funds and hedge funds. Investors can use them to diversify their investment strategy thanks to their low correlation to equity and bond markets. They are also a means of investing in alternative risk premiums, which are largely free of traditional market risks.

Actively managed investment funds
With actively managed investment funds, the fund manager chooses the mix of asset classes and individual securities in accordance with specific criteria, continually monitors the portfolio and adjusts it as required. The fund's performance is measured against a reference index known as the benchmark, and the fund manager attempts to add value for investors by constructing a portfolio that outperforms the benchmark.

Passively managed investment funds and ETFs
Passively managed investment funds, also called index funds, track a market index, which significantly reduces management costs. Their investment decisions are essentially determined by changes in the index. Passively managed investment funds thus offer a simple and cost-effective way of ensuring broad diversification. Exchange-traded funds (ETFs) normally track an index, e.g. a share, bond, money market, real estate, hedge fund, currency or commodity index. They offer the advantage of being easy to trade.

3.2.4 Funds of funds and multi-manager funds

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

Multi-manager funds spread their investments among a number of fund managers covering different investment styles, markets and financial instruments. Investors can achieve a higher level of risk diversification by investing in funds of funds and multi-manager funds, but the costs are generally higher due to the costs generated by the various underlying funds.

Investors should also bear in mind that certain categories of funds of funds and multi-manager funds domiciled in countries with strict legislation on collective investment schemes may follow strategies that are to some extent similar to those of offshore and hedge funds (see section 2.10).

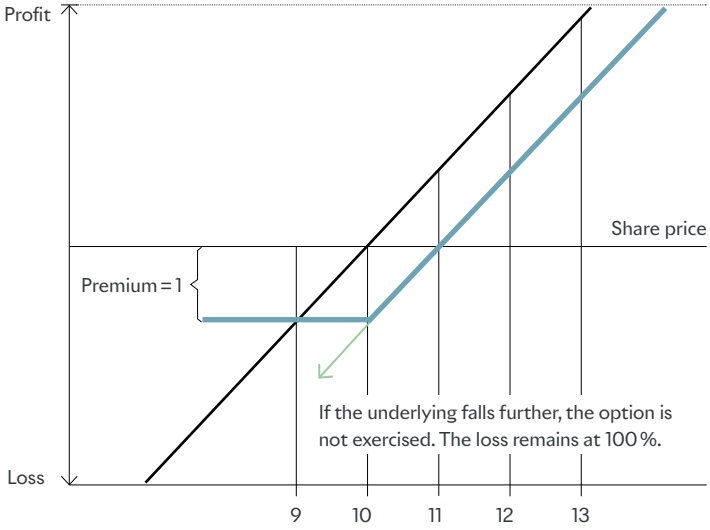
3.3 Options

How leverage works

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

Fig. 6

Example: Buying a call option



Leverage due to small amount of invested capital
The option gives the buyer the right to buy a share at a price of 10.
Invested capital (premium) = 1

Calculation:
The share price is 12. The option buyer buys the share for 10 and can then sell it for 12, leaving 2. Minus the premium of 1, this gives a profit of 1, which is equal to 100 % of the invested capital.

Call-Option
Share

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

Source: SBA

3.3.1 Types of options

Warrants
Warrants are options in securitised form that are traded on an exchange or over the counter. Exchange-traded warrants frequently involve bilateral settlement without the involvement of a central clearing house. Normal options are standardised as regards the strike price, ratio of options to underlying and term (see section 2.7). With a warrant, the issuer can determine these itself, however it usually does in line with investors' preferences in order to ensure sufficient demand for the warrant.

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

Over-the-counter (OTC) options
OTC options are neither securitised nor traded on-exchange. They are agreed directly off-exchange between the seller and the buyer. Investors who wish to cancel (close out) an option of this type before the expiry date must make a corresponding offsetting trade with the counterparty.

American-style options
American-style options can in principle be exercised on any trading day up to the expiry date.

European-style options
European-style options can only be exercised on the expiry date, in other words the date set out in the contract. However, this does not normally affect their tradability on the secondary market (e.g. via an exchange).

3.3.2 Margin cover

An investor who sells an option must deposit either the requisite quantity of the underlying or another form of collateral for the entire duration of the contract. The amount of this collateral or margin is determined by the securities dealer (see Glossary). The exchange stipulates a minimum margin for exchange-traded options (see above).

If the margin cover proves insufficient, the securities dealer can demand additional collateral. This is known as a margin call. If the investor cannot provide the collateral quickly enough, the securities dealer may unilaterally close out the option, in which case the investor loses the opportunity to profit from a favourable trend in the underlying up to expiry.

3.3.3 Settlement

Where a call option provides for physical delivery (settlement), the investor can require the option seller to deliver the underlying when the option is exercised. With a put option, the option seller is obliged to buy the underlying from the investor.

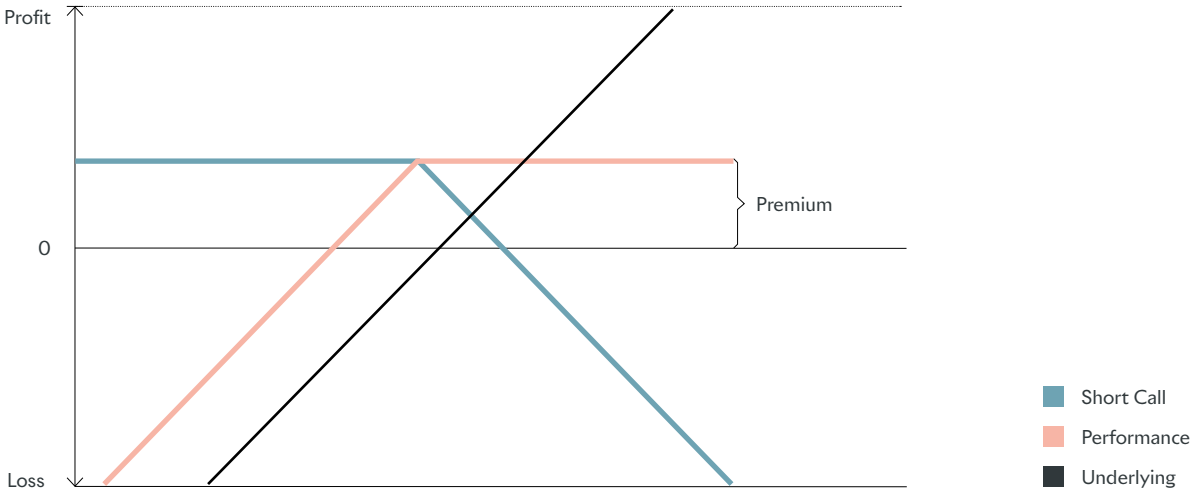
If an option provides for cash settlement, the option buyer is only entitled to a sum of money corresponding to the difference between the strike price and the current market value of the underlying.

3.3.4 Traditional and synthetic covered options

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

Fig. 7

Example: Sale of a covered call option



The investor buys an underlying (a share, bond or currency) and at the same time sells (or writes) a call option on it. The investor receives a premium for the option, which reduces the loss incurred if the price of the underlying falls sharply. By the same token, however, the potential return from any increase in market value is limited to the option's strike price.

Source: SBA

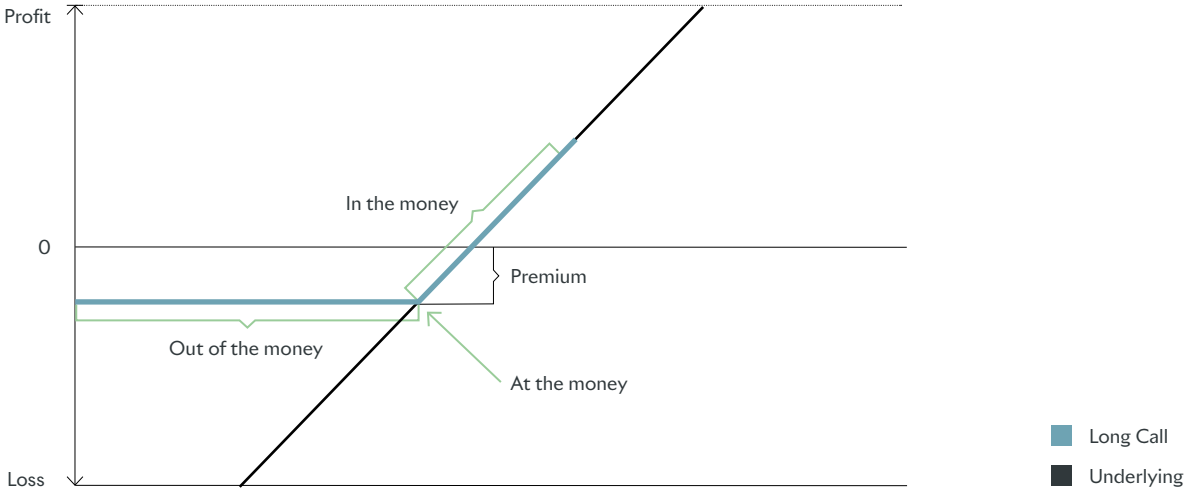
Synthetic covered options are based on the idea of replicating a traditional covered option with a single transaction. The simultaneous purchase of the underlying and sale (writing) of the call option are effected using derivatives. The purchase price of this type of financial instrument is equal to the price of the underlying minus the premium received on selling the call option. The instrument can thus be sold at a lower price than its underlying.

3.3.5 Value of an option

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

Fig. 8

Example: Call option in the money, at the money, out of the money



In the money

A call option is in the money if the current market value of the underlying is above the strike price. A put option is in the money if the current market value of the underlying is below the strike price. If an option is in the money before expiry, it has an intrinsic value.

Out of the money

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

At the money

If the current market value of the underlying is the same as the strike price, the option is at the money and has no intrinsic value.

Source: SBA

3.3.6 Special risks

As the seller (writer) of a covered call option
If an investor sells a call option and holds the requisite quantity of the underlying, the call option is described as covered. If the current market value of the underlying exceeds the strike price, the investor loses out on the capital gain as a result of having to deliver the underlying to the buyer at the strike price, rather than selling the underlying at the (higher) market value. The investor must have full power of disposal over the underlying if there is a chance that the option will be exercised. The underlying must not be pledged for other purposes, otherwise the risks are essentially the same as for selling (writing) an uncovered call option (see next paragraph).

As the seller (writer) of an uncovered call option
If an investor sells a call option but does not hold the requisite quantity of the underlying, the call option is described as uncovered. The loss risk for an option with physical delivery (see Glossary) is made up of the difference between the price the investor must pay for the underlying and the strike price the buyer pays for it – minus the premium the buyer paid for the option. The loss risk for an option with cash settlement is made up of the difference between the price of the underlying and the strike price – minus the premium the buyer paid for the option.

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

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

Investors must therefore be aware that the potential loss can be far greater than the value of the collateral (margin) deposited either when entering into the contract or thereafter.

As the seller (writer) of a put option
An investor selling a put option must be prepared for substantial losses if the market value of the underlying falls below the strike price that must be paid to the seller. The loss risk in this case is made up of the difference between these two values minus the premium the buyer paid for the option.

An investor selling an American-style put option with physical delivery undertakes to buy the underlying at the strike price when the buyer exercises the option, even if the underlying can only be sold with considerable difficulty or at a heavy loss or cannot be sold at all. The potential losses can thus be far greater than the value of any collateral (margin) that has been deposited. The maximum loss is equal to the strike price multiplied by the quantity of underlying that must be bought.

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

Either cash settlement or physical delivery of the underlying takes place on the expiry date. If the market value of the underlying on expiry is higher than the strike price, the holder of an option with cash settlement receives a specified cash amount.

If the market value of the underlying is lower than the strike price, the holder of an option with physical delivery receives the underlying and thus bears the full risk associated with it.

3.3.7 Option strategies and special options

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

Given the many possible combinations, the risks involved in any particular case cannot be covered in every detail in this brochure. Investors should inform themselves about the specific risks by reading the product's legal documentation or key information document before selecting a strategy.

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

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

The examples of exotic options listed below can be broadly divided into two categories: path-dependent options and options on multiple underlyings.

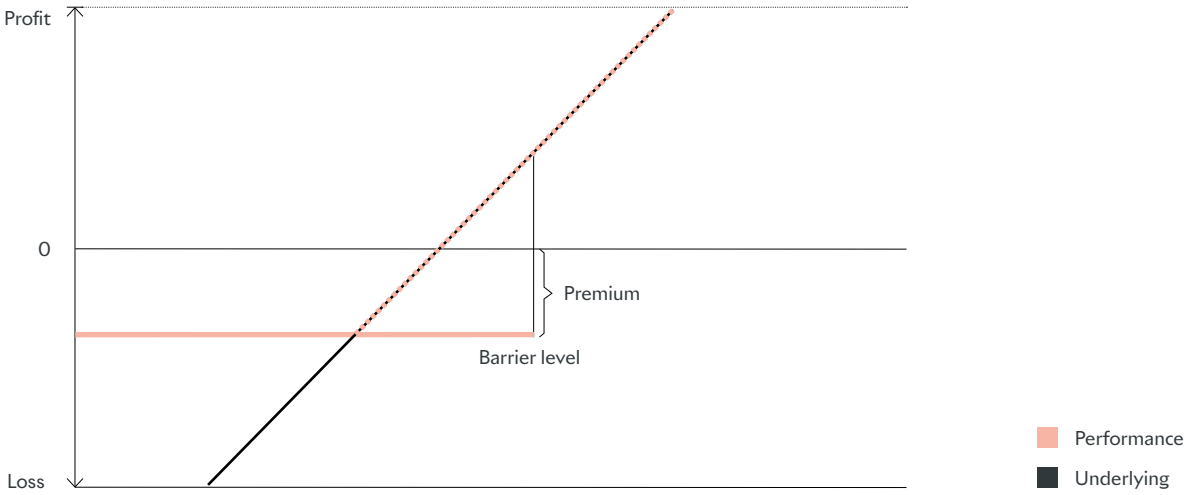
Path-dependent options

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

Examples of path-dependent options:

Fig. 9

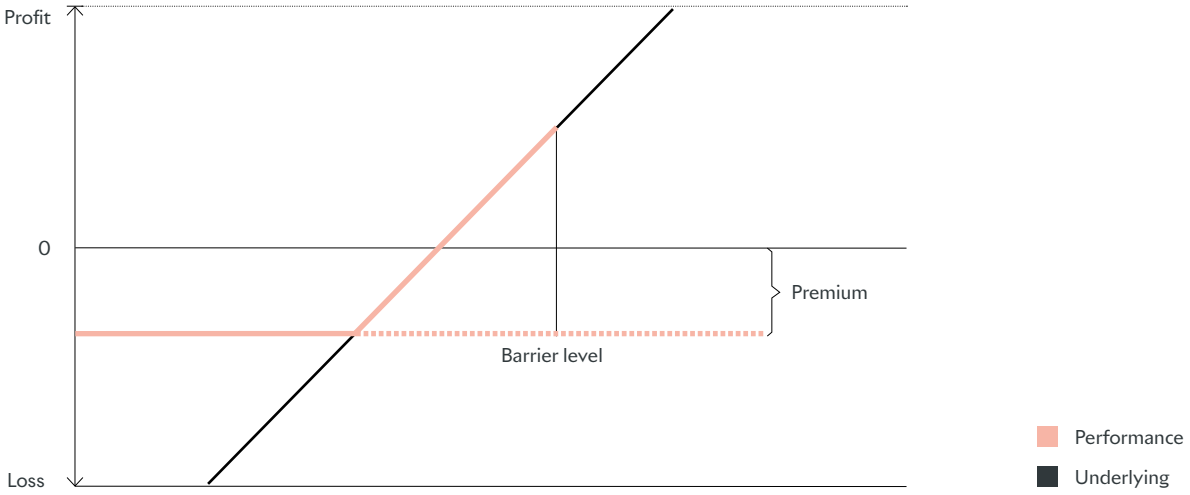
Knock-in barrier option



Exercise rights for knock-in barrier options only arise if the market value of the underlying reaches a fixed threshold (barrier) within a specified period.

Fig. 10

Knock-out barrier option



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

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

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

Investors buying a barrier option must be aware that their exercise rights only take effect (with a knock-in / kick-in option) or become entirely and irrevocably invalid (with a knock-out / kick-out option) when the market value of the underlying reaches the barrier.

Accumulator and decumulator structures of barrier options

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

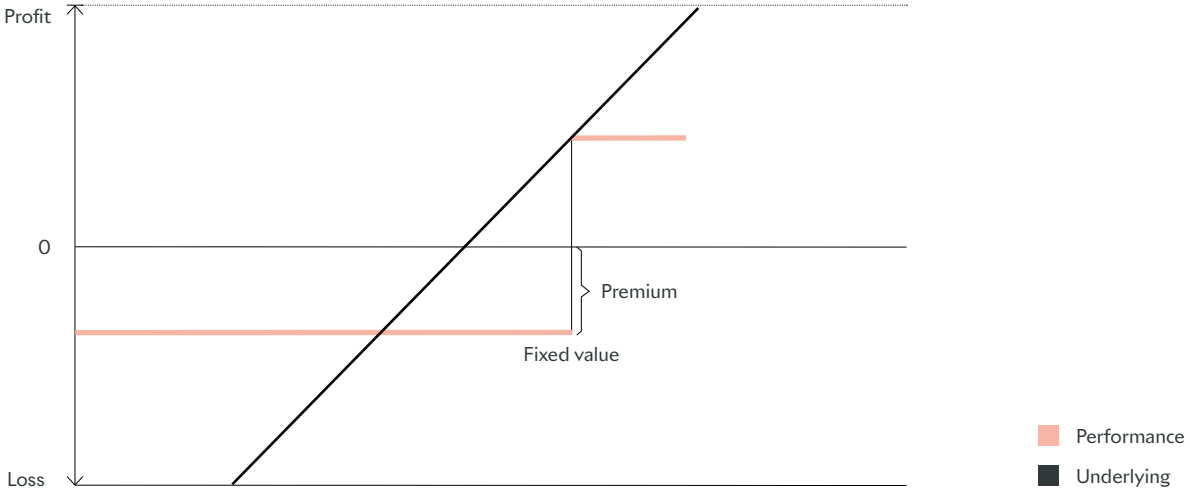
As long as the underlying does not break through the knock-out barrier, the investor accumulates the predefined quantity of the underlying in stages up to the end of the term. The investor has full power of disposal over the underlying (and can therefore sell it) as soon as each option is exercised.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

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

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

Fig. 11

Payout option



Payout options entitle investors to receive a premium that is fixed in advance.

In the case of a digital or binary option, the investor receives payment if the market value of the underlying reaches a fixed value either once during a specified time period (one-touch digital option) or precisely on the expiry date (all-or-nothing option). For the one-touch digital option, the premium is paid either immediately when the barrier is reached or on the expiry date (lock-in option). If the value is not reached during the term, the option expires with no value.

With a lock-out or no-touch option, the investor only receives the fixed payment if the market value of the underlying does not reach the agreed barrier during a specified time period, otherwise the option expires with no value.

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

Asian options

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

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

With average-strike options, meanwhile, the average strike price of a call option can be considerably higher than the price originally set. Conversely, the strike price of a put option can be lower than the price originally set.

Lookback options

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

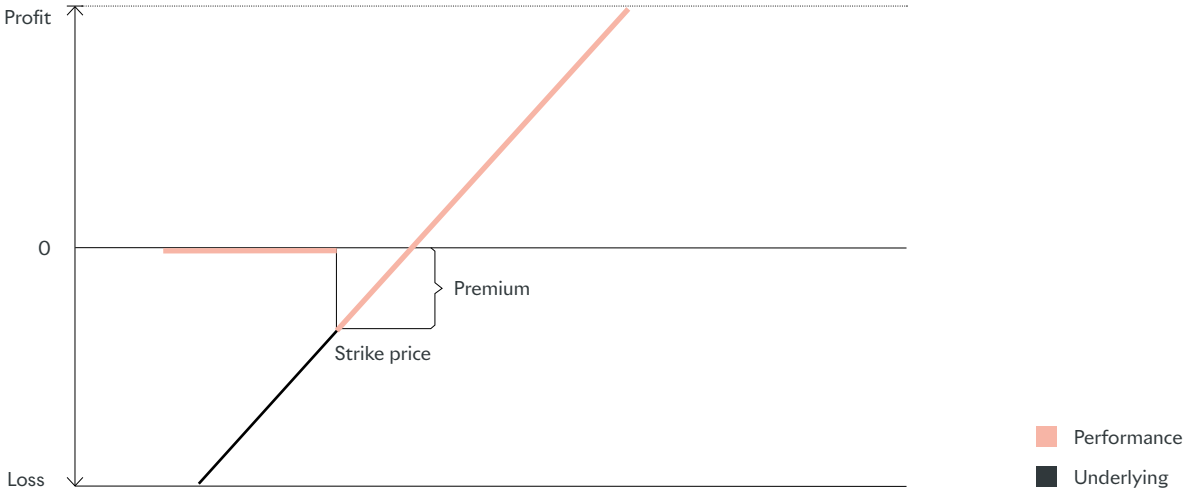
The strike price of a strike lookback option is determined by the lowest value (call option) or the highest value (put option) of the underlying.

The strike price of a price lookback option remains unchanged. Instead, the option value is calculated from the highest value (call option) or the lowest value (put option) of the underlying.

With lookback options, both the calculated strike price and the calculated value of the underlying can vary considerably from the market prices prevailing on the expiry date. Investors selling options of this type must be aware that they will always be exercised at the most unfavourable value for them.

Fig. 12

Contingent options



The buyer of a contingent option must pay the premium only if the market value of the underlying reaches or exceeds the strike price during the term of the option (American-style option, see Glossary) or on the expiry date (European-style option, see Glossary).

The buyer must pay the entire premium even if the option is only just at the money or just in the money.

Cliquet and ladder options

The strike price of a cliquet option (also known as a ratchet option) is adjusted in line with the market value of the underlying, usually at regular intervals. Any intrinsic value the option has is locked in when this adjustment is made, and these lock-ins are accrued throughout the option's term.

The strike price of a ladder option is adjusted when the underlying reaches specified market prices, rather than at regular intervals. As a rule, only the highest intrinsic value is locked in, but all intrinsic values recorded during the term may be accrued in exceptional cases.

Investors selling a cliquet option must pay the buyer all the accrued lock-ins in addition to any intrinsic value of the option on expiry. Investors selling a ladder option must pay the buyer the highest lock-in amount. It must be borne in mind that the lock-in amount may be considerably higher than the option's intrinsic value on the expiry date.

Source: SBA

Options on multiple underlyings

Spread and outperformance options are two examples of options on multiple underlyings. Both have two underlyings. The value of a spread option is calculated from the absolute difference in the performance of the two underlyings. The value of an outperformance option, meanwhile, is calculated from the relative difference, i.e. the percentage by which one underlying outperforms the other.

Even if the value of an underlying increases, the difference in performance may remain the same or even fall in either absolute or relative terms, decreasing the value of the option.

Compound options

Compound options have an option as their underlying, i.e. they are options on options. Compound options can have an especially large leverage effect. Investors selling (writing) them must be prepared for very high liabilities.

Credit default options

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

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

3.4 Structured products

Voting or participation rights

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

Special risks

Unlike with collective investment schemes, the issuer of a structured product is liable with their own assets, as is any guarantor to the extent of the guarantee; the underlying assets do not benefit from special protection. Investors must therefore be prepared to accept not just the potential loss due to the change in market value of the underlyings (market risk) but also, in the worst case, loss of their entire investment if the issuer or guarantor becomes insolvent (issuer / guarantor risk, see Glossary).

3.4.1 Capital protection products

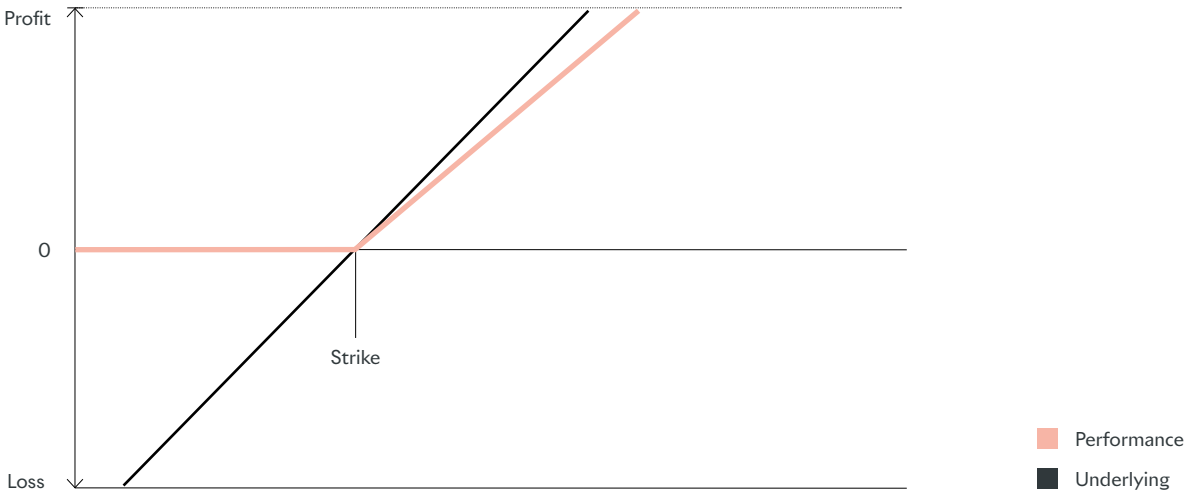
Types of capital protection

Some structured products offer capital protection. The level of this protection is fixed by the issuer when the product is issued and indicates the minimum percentage of the nominal value that will be repaid to the investor on expiry. However, capital protection only applies at the end of the term and may, depending on the product conditions, be less than 100 % of the invested capital. Only financial instruments offering 100 % capital protection guarantee that the investor will receive the full nominal value on expiry.

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

Fig. 13

Example: Capital protection with participation

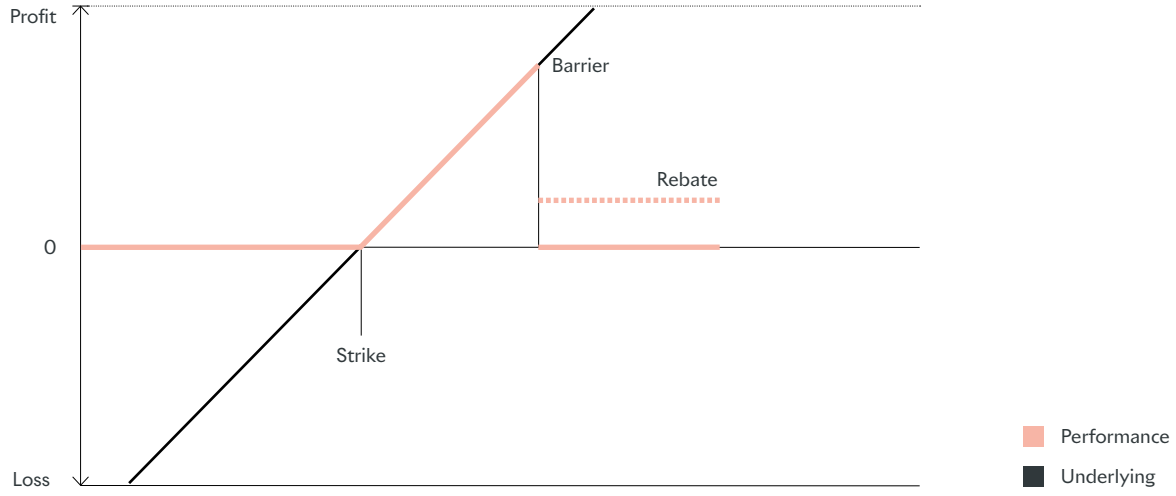


In a capital protection product with participation, the buyer participates in any further rise in the market price of an underlying once it reaches the strike price.

Source: SSPA

Fig. 14

Example: Capital protection with barrier



In a barrier capital protection product, the buyer participates in any further rise in the market price of an underlying once it reaches the strike price up to a barrier. If the price rises above the barrier, the value of the product drops back to the capital protection level. The investor receives a coupon (rebate) instead of the participation.

Source: SSPA

Fig. 15

Example: Capital protection with coupon



In a capital protection product with coupon, a regular coupon is paid out once the strike price is reached. The level of the coupon depends on the performance of the underlying.

Source: SSPA

How capital protection products work

Structured products with capital protection normally consist of two elements, such as a fixed-income investment (see Glossary, typically a bond or a money market investment) and an option. This combination allows the investor to participate in the performance of one or more underlyings through the option or participation component, while the capital protection limits the loss risk. The capital protection only covers part of the nominal value, but it defines the minimum repayment the investor receives on expiry, regardless of how the participation component performs.

Capital protection and nominal value

The capital protection is linked to the nominal value rather than the issue price or purchase price. Hence, if the purchase / issue price the investor pays exceeds the nominal value, only the nominal value is capital-protected. The protection of the investor's capital outlay drops accordingly. Conversely, if the purchase/ issue price is less than the nominal value, the protection rises accordingly.

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

An investor wishing to sell a structured product with capital protection before it expires may receive less than the value of the capital protection component, as the protection only applies if the product is held until the expiry date.

Participation component
The participation component determines the extent to which an investor can profit from the performance of the underlying(s). In other words, it fixes the level of the potential return over and above the capital protection component. Some structured products with capital protection offer only a limited potential participation (those with a cap); some (those without a cap) offer unlimited potential participation. Others require the market value of the underlying to touch, rise above or fall below a specific barrier before a profit can be made.

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

Special risks
The maximum loss on a structured product with capital protection is limited to the difference between the purchase price and the capital protection, provided the product is held until expiry. Capital protection offers no protection against issuer risk (see section 1.3). This means that if the debtor of a structured product becomes insolvent, some or all of the capital invested may still be lost.

3.4.2 Yield enhancement products

How yield enhancement products work
Structured products with yield enhancement normally consist of two elements, such as a fixed-income investment (see Glossary) and an option – normally on equities or currencies. This combination allows the investor to participate in the performance of one or more underlyings up to a cap, through the option component. However, with yield enhancement products the minimum repayment is either absent or conditional, and they normally bet on underlyings trending sideways or slightly upwards. The interest paid or discount on the issue price offers the investor a higher return than on a direct investment if the price of the underlying remains essentially unchanged. On the other hand, the investor will not benefit from the full potential return of the underlying.

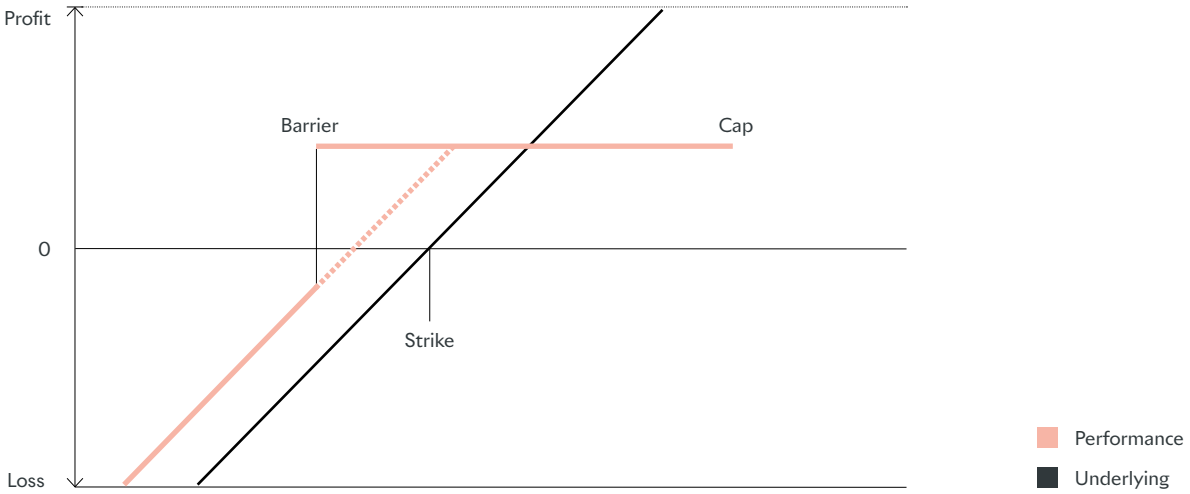
If the price of the underlying rises, the investor will receive the interest and nominal value paid out on expiry. There may also be provision for a discount on the issue price. If the market value of the underlying rises sharply, a direct investment may achieve a higher return. Conversely if it falls sharply, the investor receives a cash settlement or delivery of the underlying on expiry, and so will also participate in the negative performance of the

underlying. However, the loss incurred is reduced by the interest payment received during the term of the product, unless a discount was granted on the issue price.

Many yield enhancement products are based on more than one underlying and provide for the investor to participate in the negative performance of the worst-performing underlying on expiry, if the underlying touches, rises above or falls below a predetermined barrier during the term.

Fig. 16

Example: Yield enhancement with barrier and cap

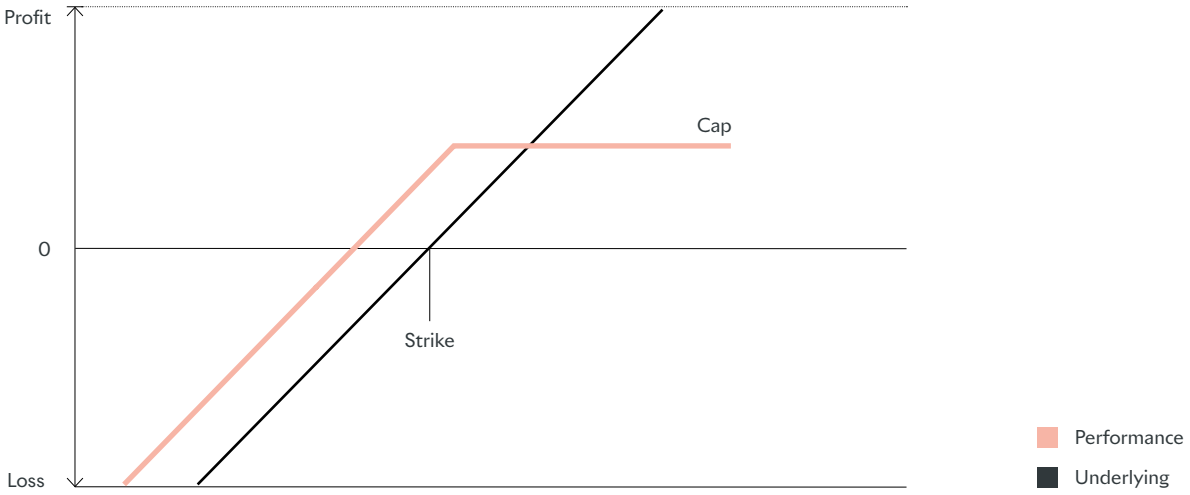


As long as the barrier is never touched, the maximum repayment (cap) or the nominal value plus a coupon is repaid. If the barrier is touched, the product is converted into a pure cap product.

Source: SSPA

Fig. 17

Example: Yield enhancement with cap



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

Source: SSPA

Special risks

If the performance of the underlying is unfavourable, the financial instrument can trade some way below the issue price during its term even if the barrier has not yet been touched, exceeded or undershot. The level of interest is directly linked to the level of the barrier, the number of underlyings and the term of the yield enhancement product. The nearer the barrier is to the market price of the underlying on the day of issue, the higher the interest the investor will normally receive. However, this also entails the risk of the barrier being reached.

In the worst case, the entire capital invested in a yield enhancement product may be lost.

3.4.3 Participation products

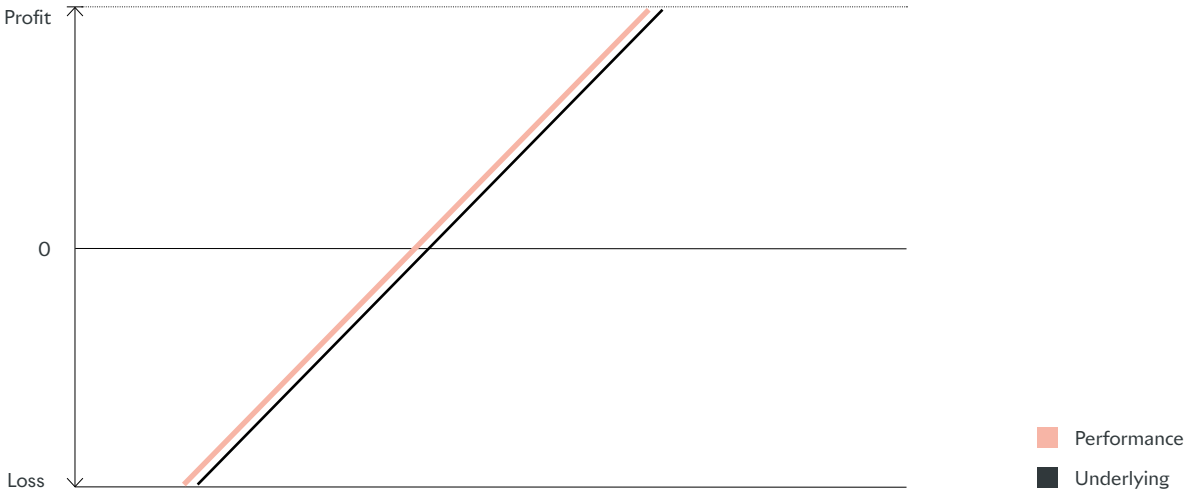
How participation products work

Structured products with participation enable the investor to participate in the performance of one or more underlyings. Often they have neither a profit ceiling nor capital protection. However, they may offer a conditional minimum repayment, in which case the risk is smaller than with a direct investment provided the market value of the underlying does not reach a specific barrier (termed the "knock-out").

If it touches, rises above or falls below the barrier, the minimum repayment is forfeited. The repayment is then dependent on the performance of one or more underlyings.

Fig. 18

Example: Classical participation

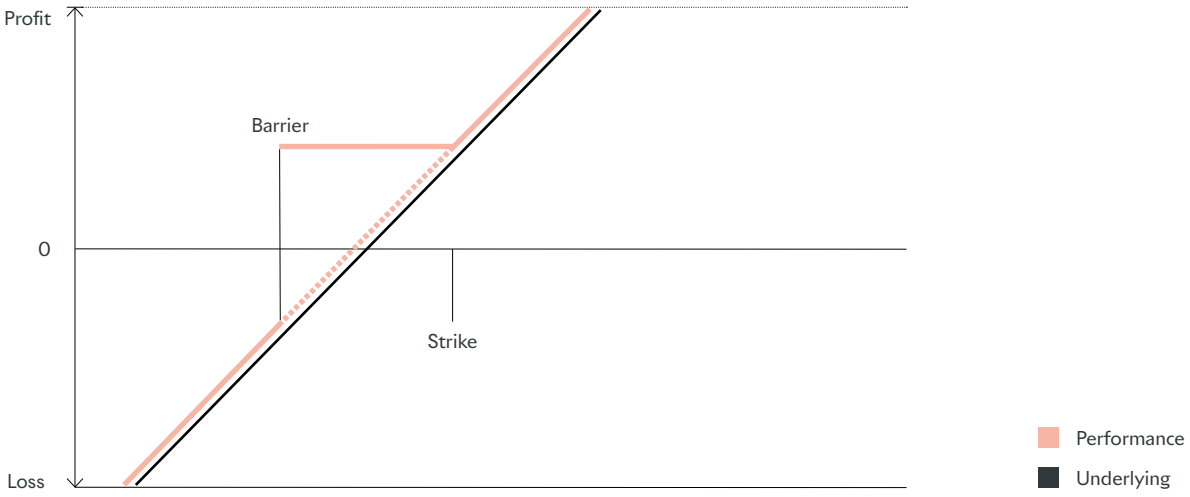


The investor participates 1:1 in the performance of the underlying.

Source: SSPA

Fig. 19

Example: Participation with barrier

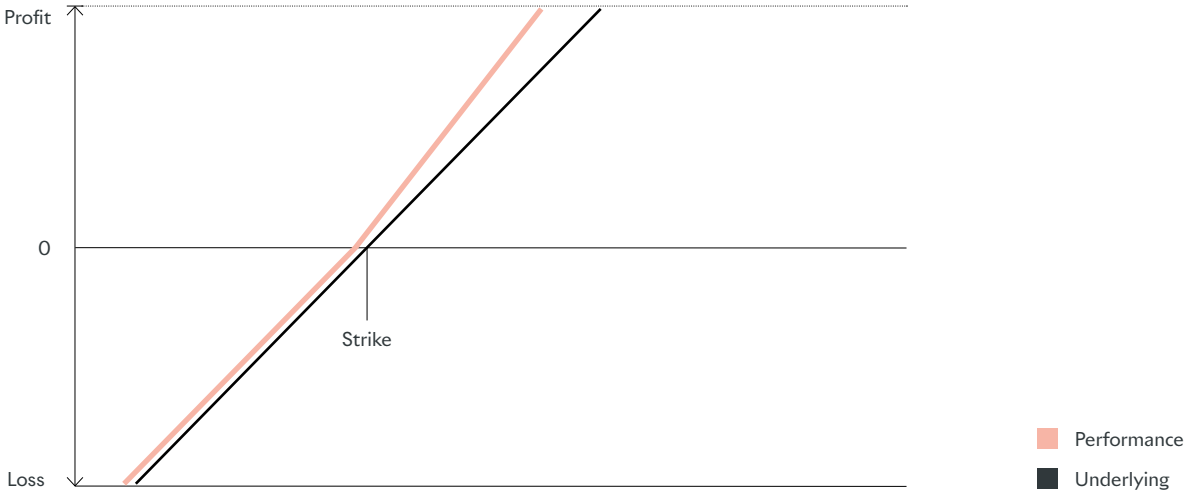


The investor participates in the performance of the underlying with minimum repayment until the barrier is reached, at which point the product is converted into a classical participation product.

Source: SSPA

Fig. 20

Example: Participation with outperformance



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

Source: SSPA

Special risks
Some financial instruments with participation are based on more than one underlying and provide for the investor to receive the security with the worst (or sometimes best) performance on expiry. The underlying is delivered or a cash settlement is paid if the underlying touches, rises above or falls below a predefined barrier during the term of the financial instrument. The financial instrument can trade some way below the issue price during its term even if the barrier has not yet been touched, exceeded or undershot. Moreover, the level of participation is directly related to the level of the barrier. An investor who has accepted a higher level of risk when choosing the barrier will participate with a larger amount.

In the worst case, the entire capital invested in a structured product with participation can be lost.

3.4.4 Investment products with a reference entity

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

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

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

Special risks of credit-linked notes (CLNs)
Credit-linked notes (CLNs) are bonds whose repayment and interest payment depend on the performance of a specific underlying or reference portfolio – such as a loan or bond.

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

3.5 Forwards and futures

How initial and variation margins work
An investor forward selling or buying an underlying asset they do not possess (short selling) must be able to supply a specified initial margin when entering into the contract. This is usually a percentage of the total value of the contracted instruments. In addition, a variation margin (see Glossary) is calculated periodically during the life of the contract. This corresponds to the book profit or loss arising from any change in the value of the contract or underlying instrument. The way in which the variation margin is calculated will depend on the rules of the exchange concerned and the terms of the contract.

The investor must deposit the required initial and variation margin with the securities dealer (see Glossary) for the entire life of the contract. In the event of a book loss, the variation margin can be several times as large as the initial margin. If the investor cannot make the variation margin payment quickly enough, the securities dealer may unilaterally close out the transaction, in which case the investor loses the opportunity to profit from a favourable trend in the underlying up to expiry.

Closing out
The investor can close out the transaction at any time before the expiry date or the next possible delivery date ("first notice day"), usually at normal market conditions. The nature of the closing out (see Glossary) will depend on the type of contract and the practice of the exchange, particularly with regard to price limits (see section 2.8). Either the financial instrument is sold, or an offsetting trade under identical contractual conditions is agreed with the counterparty so that the obligations to deliver and receive cancel one another out.

Settlement and special risks
If the transaction is not closed out before the expiry date or the first notice day, the investor and the counterparty (see Glossary) must settle it. If the underlying of a forward contract is a physical asset, the contract may provide for physical delivery or a cash payment. Generally, the asset is physically delivered. Only in exceptional cases do the contract provisions or exchange practice call for cash settlement. All other settlement specifications, especially the place of fulfilment, can be found in the relevant contract provisions.

The difference between physical delivery and cash settlement is that with physical delivery, underlyings amounting to the entire contractual value must be delivered, whereas with cash settlement, only the difference between the agreed price and the market value on settlement needs to be paid. This means that where the contract provides for physical delivery, the investor will need either more funds available than for cash settlement or the underlying assets.

3.6 Offshore funds and hedge funds

Offshore funds
In general, a distinction is made between collective investment schemes (see section 3.2) domiciled in countries with strict legislation – such as Switzerland or the EU – and those domiciled in countries with comparatively relaxed legislation – such as the Cayman Islands or British Virgin Islands. The former are referred to as onshore funds, and the latter as offshore funds.

Hedge funds
Many offshore funds are hedge funds. Despite what their name suggests, hedge funds do not necessarily have anything to do with hedging. Indeed, they sometimes take on very high levels of risk in order to obtain an above-average return. Hedge funds include forms of investment funds, investment companies and partnerships that use derivatives not just for hedging but also for investment, and that are able to engage in short selling or take on significant leverage by borrowing.

As with other types of collective investment schemes, a hedge fund's performance often depends on the expertise of a single person – the manager – or a small group of key individuals. Incorrect decisions or the loss of such people can have a direct impact on the hedge fund's performance. The dependence on a single fund manager can be reduced by, for example, investing in a fund of funds or multi-manager fund. Funds of funds invest their capital in a number of target funds. Multi-manager funds, meanwhile, are spread across a number of fund managers covering a range of investment styles, markets and financial instruments (see section 3.2.4).

Special risks

Offshore funds and hedge funds are subject to little or no regulation and minimal or no licensing requirements, and are not overseen by a supervisory authority. The same applies to their managers. In particular, offshore and hedge funds are not subject to the numerous investor protection regulations that apply to approved collective investment schemes, such as rules on liquidity, the option to redeem fund units at any time, avoidance of conflicts of interest, fair pricing of fund units, and disclosing and limiting leverage. It is often difficult or even impossible to assert the rights of investors in offshore countries if problems occur with a fund.

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

Offshore funds, and in particular hedge funds, make full use of their freedom to choose asset classes, markets – including high-risk countries – and trading methods. This can lead to greater diversification and, under certain circumstances, stable absolute returns, but in unfavourable market situations there is a risk of extremely negative performance, up to and including total loss.

Transparency

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

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

Investment techniques

The investment techniques employed by hedge funds include the extensive use of short selling, leverage, swaps, arbitrage (exploiting price or interest rate differences between markets, see Glossary), derivatives and algorithmic (automated) trading (see Glossary). The investment strategy may employ derivatives such as futures, options and swaps, which entails greater risks. These financial instruments may be subject

to significant price volatility, resulting in a high risk of loss for the fund. The low margins required to build up a position in such instruments mean that high levels of borrowing can be used. Depending on the instrument, a relatively small change in the contract price (see Glossary) can lead to a large profit or loss compared with the margin deposited. Such losses may be unforeseeable, result in further losses and exceed any margin. If a hedge fund sells uncovered options on securities, it may be exposing itself to an unlimited risk of loss.

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

Liquidity and fees

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

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

Subscription, sale and redemption

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

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

The various types of hedge fund strategies are outlined below.

Examples of hedge fund strategies

Long / short equity
Equity hedge funds identify both undervalued shares – buy or long positions – and overvalued shares – sell or short positions – in specific regions and market segments (see Glossary > Short / long position). They seek to profit from closing out the positions at a profit sooner or later.

Arbitrage
Arbitrage strategies identify price differences between identical or similar investments in different markets and try to exploit them. Such strategies include equity market neutral, fixed-income arbitrage, convertible bond arbitrage and mortgage-backed securities arbitrage.

Event-driven
Managers that pursue event-driven strategies try to make a profit from events such as upcoming changes in a company (mergers, takeovers, restructurings, turnarounds, etc.). Examples of such strategies are merger arbitrage, distressed securities and special situations.

Global macro
Hedge funds that pursue global macro strategies attempt to identify macroeconomic trends such as changes in interest or exchange rates at an early stage and exploit them for profit. This category includes growth funds and emerging market funds.

Managed futures
This type of hedge fund deals in futures (standardised, exchange-listed contracts) on financial instruments, currencies and commodities.

3.7 Private equity

Financing types and strategies
Private equity involves investments in young companies (start-ups) and companies with growth potential that are still in an early stage of their development. This category is termed venture capital. Private equity is also used to fund the growth or expansion of an existing company. This is known as late stage or mezzanine financing. Private equity also comes into play when a company is about to go public or to be sold. This type of financing aims primarily to refund the existing owners' original investment with a premium (multiple) from the proceeds of the initial public offering (IPO) or sale. Changes of ownership, for example when a company is delisted or sold to a strategic investor, generally involve some kind of buy-out: a management buy-out (MBO), management buy-in (MBI) or leveraged buy-out (LBO).

The primary goal of private equity is to invest in a company for a limited period and then sell the investment at a profit. The success of a private equity investment therefore depends not just on choosing the right time to enter or exit or sell the company, but also on the financing strategy the management has implemented. The strategies differ depending on the stage the company has reached. They include venture capital strategies, buy-out strategies, turnaround strategies and mezzanine strategies. The choice of financing solution, whether direct or indirect, will depend largely on the market conditions prevailing in the investment environment at the time. The performance of the equity and bond markets, as well as other specific private equity factors, will determine how easy or difficult the exit phase is and whether the proceeds meet expectations.

Special risks

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

Companies that are potential candidates for private equity investments may have high levels of borrowing and therefore be more sensitive than established companies to negative market developments such as rising interest rates. There is also a greater danger of the company becoming insolvent and going bankrupt than with listed companies.

Private equity investors normally undertake in advance to invest a fixed amount (capital commitment) that may be immediately and irrevocably blocked at the bank. They may lose the ability to dispose of the capital as they see fit, even if the private equity vehicle does not require actual transfer of the full sum or part of it until later. This is known as making a capital call. In other cases, investors must simply ensure that sufficient liquidity is available when a capital call is made. If they fail to meet the call within a defined time period, they may be subject to sanctions set out in the limited partnership agreement that may entail the loss of part or all of the investment.

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

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

3.7.1 Indirect investments in private equity

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

4 Appendix

4.1 Glossary

Term	Explanation
Actively managed fund	Type of investment fund in which the fund manager tries to generate added value through targeted security selection, see section 3.2.3.
Algorithmic trading	Automatic issuing of buy and sell orders controlled by computer programs.
Alternative (non-traditional) investment	An instrument that has little or no correlation with the conventional financial markets, such as equities and bonds. Examples include hedge funds, private equity and commodities.
American-style option	A type of option that can normally be exercised on any trading day up to the expiry date, see section 3.1.1.
Arbitrage	A type of exchange transaction that aims to make a profit by exploiting price or interest rate differences between various markets.
Asset allocation fund	A fund that invests in a range of different asset classes, e.g. shares, bonds and real estate. Such funds enable standardised asset management and, especially for investors investing small or medium-sized sums, permit risk diversification to match their risk profile, see section 3.2.1.
Asset-backed security (ABS)	Credit derivative backed (secured) by a portfolio or pool of assets, see section 3.1.3.
At the money	Term used when the current market value of an option's underlying asset is the same as the strike price, see section 3.3.5.
Bitcoin	A means of digital payment (cryptocurrency) based on a distributed database known as a blockchain, see "Blockchain" and see section 2.15.
Blockchain	A type of distributed ledger or shared database; in the case of bitcoin, it records payments between members of the network in a chain of blocks.
Bond	From the issuer's perspective, a bond is a kind of fixed-term loan. The issuer (borrower) normally pays a fixed rate of interest (coupon) at regular intervals, see section 2.2.
Bond fund	A collective investment scheme that invests mainly in bonds with or without fixed coupons, convertible bonds and warrant bonds as well as variable-interest bonds, see section 3.2.3.
Book-entry securities	Securities, such as equities, bonds and collective investment schemes, that are not kept in physical form but are simply booked to a securities account, see section 1.1.
Broker	A dealer or intermediary in securities, insurance policies and other financial services.
Call option	A type of option that confers the right, but not the obligation, to purchase a specified quantity of a specific underlying asset at a precisely stipulated price (strike price) either at a specific point in time (European-style option) or during a specified period (American-style option), see section 3.3.

Cap	The maximum repayment on a structured product, see section 3.4.2.
Certificate	A structured product in the form of a debt security allowing investors to participate in the performance of specific securities or other financial instruments.
Clearing / clearing house	The settlement or netting of financial instrument transactions by securities dealers; carried out by a clearing house such as, in Switzerland, SIX SIS Ltd.
Closing out	A term that originated in derivatives and futures trading, closing out refers to closing an open position by executing a corresponding opposite transaction, so that the two cancel each other out.
CoCo bond	Contingent convertible, see section 3.1.1.
Collateralised debt obligation (CDO)	A sub-category of asset-backed securities. CDOs are backed by a debt portfolio.
Collective custody	An arrangement whereby a number of investors' financial instruments are held collectively by a third-party custodian, i.e. they are not held separately for each individual investor, see section 1.4.
Collective investment scheme	A pool of assets supplied by investors to be jointly invested on their account. Collective investment schemes make broadly diversified investments possible with a small capital outlay, see section 2.4.
Commodity	A physical good, mostly in the form of a natural raw material, that is standardised when used as the underlying for a transaction. Commodity investments can be either direct or indirect, see section 2.14.
Contract price	Contractually agreed price of an investment such as a hedge fund, see section 3.6.
Convertible bond	A bond that gives the holder the right to convert it within a predefined period and at a predefined ratio into an equity instrument from the same issuer, e.g. a share, see section 3.1.1.
Correlation	A concept from statistics, correlation measures the relationship between two series of figures. In the world of finance, it measures the degree to which two investments move relative to each other.
Counterparty	The other party in a contractual arrangement.
Counterparty risk	The risk that a counterparty will not meet its obligations at the agreed time; in exchange trading, this risk is assumed by the clearing house.
Covered option	A transaction in which an investor purchases an underlying asset – a share, bond or currency – and simultaneously writes (sells) a call option on the same asset, see section 3.3.4.
Credit and catastrophe derivatives	Financial instruments used for financing or risk transfer purposes where the underlying is an event, such as a credit event or a natural disaster, see section 2.9.
Credit-linked note (CLN)	Structured product in the form of a bond where repayments and interest depend on the performance of a specific underlying or reference portfolio.
Credit risk	The risk of loss if a party to a transaction becomes insolvent. With debt instruments such as bonds, this risk is known as the issuer risk because the borrower normally acts as the issuer, see section 1.3.
Currency risk	Risk of exchange-rate fluctuations if the reference currency is not the currency of the financial instrument, see section 1.3.

Custody chain	Custody of financial instruments is routinely handled by a number of parties making up what is known as the custody chain, see section 1.4.
Debt instrument	Any kind of security that is not an equity security, e.g. a bond.
Derivative	A financial contract where the price is derived either from assets such as equities, bonds, commodities or precious metals or from variables such as exchange rates, interest rates and indices.
Direct investment	An investment that involves directly acquiring the asset concerned rather than a financial instrument based on it, see section 1.1.
Discount	A reduction granted on, for example, an issue price, see section 3.4.2.
Dividend rights certificate	A form of equity security embodying a share in a company that grants the holder specific rights in respect of the company, see section 2.1.
Emerging market	A country that has not yet acquired all the features of a fully developed market, see section 1.3.
European-style option	A type of option that can only be exercised on a specific expiry date, see section 3.3.1.
Exchange trading	Trading, in particular in financial instruments (certificated and uncertificated / book-entry securities), on an organised, regulated market referred to as a secondary market, as distinct from issuance, which constitutes the primary market, see also "Issue / issuance".
Expiry date	In an option transaction, the date on (or until) which the agreement between the buyer and seller confers the right to buy or sell a specific underlying asset at a predefined price, see section 2.5.
Financial instrument	Term for any kind of certificated or uncertificated security or derivative, including those that are not standardised and suitable for mass trading; see also the definition in the Financial Services Act (FinSA), see section 1.1.
Financial intermediary	A natural person or legal entity that, in return for payment, accepts assets from third parties and holds them in custody or assists in investing or transferring them.
Financial service provider	A person or entity that provides financial services in Switzerland or to clients in Switzerland on a professional basis, professional being defined as involving an independent economic activity conducted on an ongoing basis for profit, see section 1.1.
Financing level	In a mini-future, the financing level determines the level of debt financing and therefore the mini-future's value, see section 2.7.
Fixed-income investment	A type of investment that has a specific term and pays interest on specific dates. Examples include bonds and money market investments.
Forward	A customised contract for the purchase or sale of an asset at a future date. Forwards are not traded on an exchange, see section 2.8.
Forward / future	An agreement whereby a buyer and a seller undertake to buy and sell a specific underlying at a predefined price at a specific date in the future (the expiry date), see section 2.8.
Fund of funds	An investment fund that invests in a number of other funds, see section 3.2.4.

Future	A standardised contract for the purchase or sale of an asset at a future date. Futures are traded on an exchange, see section 2.8.
Guarantor risk	Risk of the guarantor of a structured product becoming insolvent, see section 3.4.
Hard currency reserves	Reserves in hard or stable currencies with exchange rates that are stable or rising against other currencies in the medium and long term.
Hedge fund	A type of collective investment scheme that is subject to limited or no regulation and supervision. Hedge funds often adopt aggressive strategies and use investment techniques that decouple investment performance from the performance of the underlying markets, see section 2.10 and section 3.6.
Hybrid bond	A type of debt instrument that contains equity-like elements, see section 3.1.2.
Hybrid financial instrument	Type of financial instrument, such as a convertible bond, that combines the features of various investment instruments that are often exchanged for each other. It may have characteristics of both equity and debt.
In the money	A call option is in the money if the current market value of the underlying is above the strike price. A put option is in the money if the current market value of the underlying is below the strike price, see section 3.3.5.
Indirect investment	An indirect investment involves acquiring an interest in the underlying asset via an investment vehicle, see section 1.1.
Ingot	A bar or block of a precious metal, see section 2.13.
Initial coin offering (ICO)	In an initial coin offering, investors transfer financial assets to the ICO organiser, usually in the form of cryptocurrencies. In return, they receive blockchain-based "coins" or "tokens", see section 2.15.
Initial margin	The sum of money required to be deposited as security / collateral when concluding a forward contract involving short selling, see section 3.5.
Initial public offering (IPO)	First-time offering of shares in a company to the public: when a private company whose shares had previously been held by a restricted group of persons is transformed into a public company by issuing shares to the public and listing them on an exchange; not to be confused with an "issue".
Investment	An allocation of money with a view to obtaining a financial benefit (return).
Issue / issuance	The creation and first-time issuing of financial instruments on the primary market (as distinct from an initial public offering).
Issuer	Entity that offers or intends to offer securities for sale.
Issuer risk	Risk of the issuer of the financial instrument becoming insolvent, see section 1.3.
Key information document (KID)	Publication issued by a financial service provider designed to explain the risks and costs of a financial instrument to retail clients in terms that are easy to understand; required under the Financial Services Act (FinSA).
Leverage	Disproportionate participation in changes in the price of an underlying, involving greater risks for the investor, see section 3.3.
Liquidity risk	The risk that an investor will not always be able to sell an investment at an appropriate price, see section 1.3.

Margin call	Limited or unlimited obligation, imposed by the law or a contract, to deposit further collateral over and above those already made under certain circumstances.
Market risk	The risk of price fluctuations within a given period due to factors impacting a specific market. Volatility is the generally accepted measure of market risk, see section 1.3.
Minimum repayment	If the level of capital protection offered by a structured product is less than 90 %, it is normally referred to as a minimum repayment product rather than a capital protection product. Used in connection with yield enhancement and participation products, see section 3.4.1.
Money market fund	A type of fund that invests in short-term, fixed-income investments and is suitable for short-term investment purposes, see section 3.2.3.
Mortgage-backed security (MBS)	A credit derivative in which the security is backed by a portfolio of mortgages.
Multi-manager fund	Type of fund that spreads its investments among a number of fund managers covering different investment styles, markets and financial instruments, see section 3.2.4.
Net asset value (NAV)	The total value of a fund's assets minus its liabilities, measured as the price of a fund unit or share on a given date.
Nominal value	The value stated on the face of a security.
Offshore fund	A collective investment scheme domiciled in a country with relatively relaxed regulatory and tax legislation; examples include the Cayman Islands and the British Virgin Islands, see section 3.6.
Open-ended collective investment scheme	A contractual investment fund in which investors are normally allowed to redeem their units at any time and new investors can join at any time, see section 3.2.1.
Option	An agreement between a buyer and a seller conferring the right to buy or sell a specific underlying asset (often referred to simply as the "underlying") at a predefined price at or before a specific point in time (the expiry date), see section 2.5. and section 3.3.
OTC derivative	A derivative that is traded over the counter (OTC) rather than on an exchange.
OTC (over-the-counter) option	A type of option that is neither securitised nor traded on-exchange. Such options are contracted directly off-exchange between the seller and the buyer, see section 3.3.1.
Out of the money	A call option is out of the money if the current market value of the underlying is below the strike price. A put option is out of the money if the current market value of the underlying is above the strike price, see section 3.3.5.
Participation component	In a structured product, the component that determines the extent to which an investor can profit from the performance of the underlying(s), see section 3.4.1.
Passively managed investment fund	Type of investment fund, also called an index fund, that tracks a market index. It is a simple and inexpensive way of achieving broad diversification, see section 3.2.3.
Path-dependent option	A type of option that requires the investor to consider not just the market value of the underlying at the time the option expires or is exercised but also fluctuations in the price of the underlying during the life of the option, see section 3.3.7.
Physical delivery	In addition to cash payment, financial instruments can provide for delivery of, for example, the physical asset underlying an option, with the associated settlement risk, see section 3.3.3.

Plain vanilla option	A conventional call or put option without additional features, see section 3.3.7.
Private equity	A form of investment to provide risk capital financing for companies that either are not listed on a stock exchange or (in exceptional cases) wish to delist, see section 2.11 and section 3.7.
Publication requirement	The Collective Investment Schemes Act imposes wide-ranging publication requirements on contractual investment funds, with regard to the issue and redemption price and net asset value.
Put option	A type of option that gives the buyer the right, but not the obligation, to sell a specific quantity of an underlying asset at a predefined strike price during or at the end of the option's term.
Ratio	In the context of options, the ratio of the underlying to a single option, see section 3.3.1.
Real estate fund	Collective, indirect investment in real estate, see section 2.12 and section 3.2.3; see also "Real estate investment trust (REIT)", section 2.12.
Reference currency	Currency in which an investment portfolio or custody account is administered and settled.
Reference entity	Structured products with a reference entity have a basic structure that, in addition to a conventional capital protection, yield enhancement or participation product, includes an additional reference (e.g. corporate or government) bond, see section 3.4.4.
Risk premium	The difference between the returns on a risky and a risk-free investment.
Secondary market	The market on which investors buy and sell (previously issued) financial instruments they already own.
Securities dealer	Natural person, legal entity or partnership that, on a professional basis, either offers financial instruments (see "Security") publicly on the primary market or trades them on the secondary market or that creates and publicly offers derivatives (see "Derivative").
Security	Standardised, certificated or uncertificated security, derivative or book-entry security suitable for mass trading.
Segregation	In the event that a bank or securities dealer acting as custodian goes bankrupt, the owners of custody account assets (e.g. movable objects and securities) are entitled to have those assets segregated from other assets (see Art. 37d BA, Art. 17 FISA, Art. 35 CISA). This has the effect of excluding the assets from the bank or securities dealer's bankruptcy assets and ensuring they remain with the account holder.
Settlement	Performance of an obligation, for example to deliver a financial instrument on the expiry date, see also "Settlement risk".
Settlement risk	Risk of having to buy a financial instrument at a specific price before delivery or of having to deliver it without receiving the purchase price, see section 1.3.
Share	Equity security embodying ownership of a share in the equity of a public limited company, see section 2.1.
Short / long position	Terms used in the financial world to refer to selling and buying positions, respectively. In general, a "long" position is one in which the investor expects the price of a financial instrument such as a share or derivative to rise, while a "short" position – effected for example by short selling – is one where the expectation is that it will fall.

Short sale	The forward sale of an underlying the seller does not hold at the time the contract is signed. It entails a risk in that the seller may have to buy the underlying at a price higher than the agreed price in order to meet the delivery obligation on expiry. Some exchanges no longer allow short sales, see section 2.8.
SICAF	Collective investment scheme in the form of an investment company with fixed capital, see section 3.2.1.
SICAV	Collective investment scheme in the form of an investment company with variable capital, see section 3.2.1.
Smart contract	Type of contract that can be concluded via a blockchain, with all stages of settlement and implementation being automated and no institution or intermediary having to oversee or intervene in the process, see section 2.15.
Strike (price)	The price at which the buyer of an option has the right to purchase (call) or sell (put) the underlying assets.
Structured product	A financial instrument based on one or more underlying assets and, often, a derivative component as well, see section 3.4.
Swap	A contract for the exchange of payment streams; not traded on an exchange or via mass trading; see also "OTC derivative".
Third bankruptcy class	The lowest-ranked bankruptcy class, comprising non-privileged claims.
Time value of an option	The time value of an option is determined by a variety of factors, including its remaining term and the volatility of the underlying. It reflects the chance that the option will be in the money, see section 3.3.5.
Token	Blockchain-based currency unit, also known as a coin, see section 2.15.
Trade repository	A database providing for the centralised electronic recording of derivative transaction data.
Treasury bill	A US money-market product consisting of a bond in certificated or uncertificated form that is issued for short-term financing purposes; comparable with Swiss Confederation bonds, see section 2.3.
Underlying	The asset (e.g. share, bond, index, currency or commodity) on which a derivative (e.g. option, warrant or future) is based.
Variation margin	When short selling on a futures contract, the investor is required to deposit an initial margin when the contract is concluded. The variation margin is an additional figure calculated periodically during the life of the contract; see also "Margin call" and section 3.5.
Venture capital	An asset class in private equity involving investments in young companies (start-ups) and companies with growth potential that are still in an early stage of their development, see section 3.7.
Volatility	The extent of the price fluctuations of financial instruments during a specific period. Volatility is a measure of market risk, see section 1.3.
Waiver	A written statement of consent to the disclosure of information, overriding protection of that information the client may otherwise be entitled to, see section 1.4.
Warrant	An option in securitised form that is traded on an exchange or over the counter, and in which the issuer can set the specifications, see section 3.3.1.

4.2 List of abbreviations

AMLA	Anti-Money Laundering Act
BA	Banking Act
CDO	Collateralised debt obligation
CISA	Collective Investment Schemes Act
CISO	Collective Investment Schemes Ordinance
CLN	Credit-linked note
CO	(Swiss) Code of Obligations
etc.	et cetera
fig.	figure
FinIA	Financial Institutions Act
FINMA	Swiss Financial Market Supervisory Authority
FINMASA	Financial Market Supervision Act
FinSA	Financial Services Act
FISA	Federal Intermediated Securities Act
FMIA	Financial Market Infrastructure Act
ICO	Initial coin offering
IPO	Initial public offering
KID	Key information document
OTC	Over the counter
SBA	Swiss Bankers Association
SICAF	Investment company with fixed capital
SICAV	Investment company with variable capital
SPV	Special-purpose vehicle
SSPA	Swiss Structured Products Association
UCITS	Undertaking for collective investments in transferable securities

4.3 List of references

Anti-Money Laundering Act
Federal Act on Combating Money Laundering and Terrorist Financing (AMLA); SR 955.0

Banking Act
Federal Act on Banks and Savings Banks (BA); SR 952.0

Code of Obligations
Federal Act on the Amendment of the Swiss Civil Code (Part Five: The Code of Obligations) (CO); SR 220

Collective Investment Schemes Act
Federal Act on Collective Investment Schemes (CISA); SR 951.31

Collective Investment Schemes Ordinance
Federal Ordinance on Collective Investment Schemes (CISO); SR 951.311

Federal Intermediated Securities Act
Federal Act on Intermediated Securities (FISA); SR 957.1

Financial Institutions Act
Federal Act on Financial Institutions (FinIA); SR 954.1

Financial Market Infrastructure Act
Federal Act on Financial Market Infrastructures and Market Conduct in Securities and Derivatives Trading (FMIA); SR 958.1

Financial Market Supervision Act
Federal Act on the Swiss Financial Market Supervisory Authority (FINMASA); SR 956.1

Financial Services Act
Federal Act on Financial Services (FinSA); SR 950.1

FINMA Guidance 04 / 2017
Regulatory treatment of initial coin offerings

Swiss Civil Code
SR 210

Swiss Structured Products Association (SSPA)
www.sspa.ch

UCITS Directive
Council Directive 85 / 611 / EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

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