

Characteristics of and risks associated with Financial Instruments

This document gives general information of characteristics of, and risk associated with Financial Instruments, including shares, share related instruments, bonds, mutual funds, options, forwards/futures contracts and other derivative instruments. Please note that the following description is of a general nature and investors have a personal responsibility to ensure that they are fully informed about the particular characteristics and risks of securities in which they invest.



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1 Definitions

American option	An option that the Holder may demand to exercise, in whole or in part, at any time prior to the agreed time on the expiration date.
Clearing	The function as a counterparty between the parties to derivatives contracts or share trades that guarantees that the parties will receive settlement for the contract/trade.
Contract for difference (CFD)	A contract according to which both the buyer and seller are bound to agree to a monetary settlement of the price developments of an agreed volume of one or a group of financial instruments, indices, currencies or similar. The buyer of a CFD makes a gain if the price rises and a loss if the price falls. A CFD does not have a predetermined expiration date but the buyer may close the position at any time.
Credit Default Swap (CDS)	A contract which provides a buyer with an insurance against the issuer of a debt obligation being unable to settle the debt, in whole or in part, on the settlement date.
Credit risk	The risk of an issuer or a counterparty being unable or less able to pay.
Dark pool	A marketplace where participants can submit orders that are not shown in the order book but are automatically matched if another participant submits a corresponding order. There is often a requirement that such orders must be a minimum size and that matching must automatically take place at the mid-price, i.e. the average of the best bid and ask prices in the open order book. Some dark pools also allow investors to submit their orders to the pool themselves. The legislation stipulates a limit on the percentage of the sales in one listed share that can be traded in one single dark pool (4% of the total volume) over a certain period and the percentage that can be traded in total in dark pools (8% of the total volume) over a certain period.
ETP (Exchange Traded Products)	ETP (Exchange Traded Products) is a generic term for ETF (Exchange Traded Funds)
ETF (Exchange Traded Funds)	These products are traded in various trading systems, such as the various Euronext Exchanges and Oslo Børs. They allow exposure to shares, indices, currencies, commodities and suchlike. Some of the products include a gearing element. The exposure can either be to a falling/bear market (short) or a rising/bull market (long). There may be huge variations in the way in which these products are structured, so investors must find out a lot about the product they choose.
European option.	An option that the Holder may only demand to

	exercise on the expiration date.
Exercising option	An option means demanding the trading of the underlying financial instrument in accordance with the option contract. Normally, the Holder may demand the partial exercise of the option while the option is maintained for the residual quantity.
Financial instruments	Generic term for the assets and liabilities that are traded in the securities market, derivative market and in part currency market and is further defined in the Norwegian Securities Trading Act.
Forward/futures contract	A contract according to which both the buyer and seller agree that an agreed volume of financial instruments will be transferred from the seller to the buyer at an agreed price on an agreed date that is further into the future than the normal settlement period for the underlying financial instrument covered by the contract.
Forward/futures price/rate	The agreed price or rate for the settlement of a forward/futures contract.
Hedge shares/hedge	If the seller of an option, forward/futures contract or swap does not want to have any price risk, he/she buys or short sells a quantity of the underlying securities so that any increase in the value of the sold derivative is offset against a corresponding increase in the value of the underlying securities. The securities that in this way protect the issuer against a price risk are often called hedge shares or a hedge.
Index option/index futures contract	A contract where the underlying asset is an index value, not a security. Such a contract is not settled t by delivering financial instruments but by calculating the contract's monetary value.
Interest rate risk	The risk of the financial instrument that the client invests in falling in value due to changes in the market interest rate.
Multilateral Trading Facility (MTF)	An MTF is not a regulated market; it is a trading venue for the sale of financial instruments. All investment firms that meet the objective requirements set by the MTF may trade on the MTF. Operating an MTF requires a licence.
Mutual (securities) fund	A mutual (securities) fund is a "portfolio" of different financial instruments, such as shares and/or bonds. The fund is owned by all those who save in the fund, the unit holders , and is managed by a management company .
NIBOR interest rate	An interest rate that is calculated by Oslo Børs according to rules determined by Finance Norway and states the market interest rate for unsecured loans in NOK. The interest rate is determined daily for various terms to maturity.
Option	A contract that gives one party (the Holder) for a limited period a right but no obligation to buy (a Call Option) or sell (a Put Option) an agreed volume of financial instruments at a predetermined price

	from/to the other party (the Writer).
Option premium	The amount the Holder has paid the Writer to purchase an option.
Organised Trading Facility (OTF)	An OTF is not a regulated market, it is a trading venue for bonds, structured financial instruments, emission quotas and derivatives. Operating an OTF requires a licence.
Price swap	A contract linked to an agreed volume of financial instruments, a settlement price (the swap price) and a settlement date, and according to which the underlying financial instruments are not to be delivered but there is instead to be a monetary settlement based on the difference between the swap price and the market price on the expiration date.
Regulated market	A regulated market is a market for the sale of financial instruments. A regulated market has a licence and is subject to a number of rules and obligations.
Securities swap	A combination of short and long positions in (at least) two financial instruments, in which the change in the price of one of the instruments (the long position) is netted against the change in the price of the other instrument (the short position) with respect to shares, government bonds and credit default swaps (CDS).
Settlement date	The date when a forward/futures contract, option or price swap is finally settled by the underlying financial instruments being delivered in return for the agreed purchase price, or the monetary settlement falling due for payment. The settlement date is normally two stock market days after the execution date.
Short sale	The sale of financial instruments that a party does not own, but has borrowed to carry out settlement on time. The financial instruments are bought at a later date and handed back to the lender. A short sale where the seller has not borrowed the underlying financial instruments is called a naked short sale and is illegal in Norway.
Short trading	Means to sell financial instruments that one does not own. According to Norwegian law, uncovered short sales are illegal, so that anyone selling short has to borrow the financial instruments from the investment firm or in some other way ensure access to the instruments on the settlement date. At the same time, the borrower undertakes to return instruments of the same type to the lender on a predetermined later date
Spot price/rate	The price at which the security is traded at for normal delivery on the second stock market day after the trading date.

Strike price/rate	The agreed price or rate for the exercise of an option.
Stock exchange	A stock exchange is a regulated market that has a special licence to operate as a stock exchange and is entitled to use the term "stock exchange" in or in addition to its name.
Swap price/rate	The agreed price(s) or rate(s) to be used when settling the individual elements in a swap.
Systematic Internaliser (SI)	An investment firm that carries out extensive own-account trading in financial instruments with clients must register as an SI for the financial instrument in question. An SI is obliged to offer binding bid and ask prices and to notify its clients of these.
Underlying assets/underlying financial instrument(s)	These are the assets or financial instruments that a derivative contract gives the parties the rights and obligations to buy or sell or that the parties have agreed to base a monetary settlement on.

2 Responsibility for Risk

Pursuant to the European Markets in Financial Instruments Directives (MiFID II), Clarkson Securities AS (“CS”) has to ensure that its clients, prior to dealing with financial instruments, are provided with sufficient information in relation to the nature and risks of such instruments. The client has to be enabled to understand the risks involved in order to take investment decisions on an informed basis. This document is intended to provide the client with a brief outline of the main characteristics and risks associated to financial instruments in which you may invest concerning the types of trading and investments which can involve special risk. Please note that this document does not deal with tax or legal consequences pertaining to transactions in financial instruments. CS recommends requesting tailor-made advice on these issues from specialists prior to any investment.

The client is personally responsible for the risk and must fully understand the conditions for trading in financial instruments. The client must become acquainted with the general business terms, prospectuses and other relevant information in effect for trading in such instruments and with the instruments’ individual risks and characteristics. The client must also on a continuous basis monitor his/her positions in such instruments. This also applies in the event the client has received personal advice in connection with the investment. Price information of the relevant financial instruments that are traded on regulated markets is daily published through the relevant stock exchange’s web page, in newspapers, information providers or through other media. The client may also retrieve price information from CS by contacting his/her broker.

The client must take any necessary action to avoid the risk of losses on own positions. If required, the client should respond quickly, for example by selling investments developing in a negative way, providing additional security to meet any margin requirements or provide additional collateral to an investment that is debt financed and where the collateral value is reduced.

It is a condition for all trading in financial instruments that the client fully understands the following:

- All trading with financial instruments take place at the clients own risk.
- The client is required to carefully study Clarkson Platou Securities AS general business terms, best execution policy, this risk document, laws and regulations in addition to relevant information on trading with financial instruments including derivatives before commencing trading.
- The client need to carefully control contract notes immediately by receipt and complain immediately in the event of irregularities.
- The client shall regularly monitor any changes in value of own holdings in financial instruments.
- The client must take any necessary actions required to avoid the risk of losses of own positions by selling his/her positions or provide additional security if necessary to avoid the risk of losses.

3 Risks associated with trading in Financial Instruments

3.1 General risk information

Investments in financial instruments are associated with financial risk.

Financial instruments normally provide a return in the form of dividends (shares and mutual fund units) or interest (interest bearing instruments). In addition, the price of the instrument may increase or decrease compared to the price when the investment was made. In the description below, the word investment also means any negative positions in the instrument as for example short positions (see clause 4.5 below). The total return is the sum of the dividend/interest and the change in the market value of the instrument.

Naturally, the investor is seeking a total return that is positive, i.e. a profit. However, there is also a risk that the total return will be negative, i.e. that the investor will make a loss on the investment. The risk of loss varies between different instruments. Normally the chance of making a profit on an investment in a financial instrument is linked to the risk of loss. The longer the investor intends to keep the investment, the greater the chance of making a profit or risk of loss. In an investment context, the word risk is often used to express both the risk of loss and the chance of making a profit. In the description below, however, the word risk is used solely to designate the risk of loss. There are various ways of investing in financial instruments in order to reduce the risk. It is normally better from a risk point of view to invest in several different financial instruments rather than a single one or only a few financial instruments. These instruments should have properties which mean the risk is spread and should not gather risks that may be triggered simultaneously. Trading in foreign financial instruments also involves a currency risk.

Derivative instruments, such as options, forwards, futures, etc., are issued for a variety of underlying assets, including shares, bonds, precious metals and currencies. Derivative instruments may be used to decrease the risk of an investment or to produce greater returns. Some derivative trades may entail the client having to provide separate security (margin requirement), for example in the case of the sale of options without owning underlying shares or corresponding options, and the purchase and sale of forward/futures contracts and swap agreements. However, the margin requirement will vary depending on such things as the underlying security, type of instrument and the instrument's term to maturity and volatility. The margin requirement may also vary considerably from day to day. The client should, in his/her own interests, be prepared to take swift action should this prove necessary, for example by providing further security (to meet any margin requirement) or by terminating his/her investments in derivative contracts (closing out his/her positions) through the purchase or sale of (offsetting) contracts if this proves necessary.

3.2 Types of risk

In connection with the risk assessment that an investor should conduct when investing and trading in financial instruments and should continue to carry out during the entire investment period, there are many different types of risk and other factors that the client should be aware of. Below are some of the most important types of risk. The following overview does not give an exhaustive list or description of all risks related to investment and factors that are not listed here may impact the value of the relevant financial instrument. Therefore, the client must, depending on specific circumstances, carefully analyse and independently assess other risks relating to investment activities and take their possible impact and consequences into account.

3.2.1 Market risk

Market risk is the risk that the entire market, or certain parts of the market, in which the client has invested declines (for example the Norwegian stock market). Adverse price movements may be caused, for instance, by poor economic indicators of the respective state or branch of the economy, unstable economic environment, unstable securities market, etc.

3.2.2 Industry specific risk

Industry specific risk is the risk that a specific industry performs worse than expected or is affected by a negative incident so that the financial instruments linked to the companies in the industry in question may decrease in value.

3.2.3 Company specific risk

Company specific risk is the risk that a company performs worse than expected or that the company in question is affected by a negative incident so that the financial instrument linked to the company may decrease in value.

3.2.4 Price risk

Price risk is the risk that the price of a financial instrument will decrease.

3.2.5 Currency risk

Currency risk is the risk that a foreign currency to which the investment is linked falls in value (for example certain fund units in a mutual fund which has invested in US securities listed in USD).

3.2.6 Credit risk

Credit risk is the risk that the issuer or a contracting party will become unable to pay.

3.2.7 Liquidity risk

Liquidity risk is the risk that the client cannot sell a financial instrument at a time when the client wishes to do so because the turnover in, and interest in buying the financial instrument is low.

3.2.8 Interest rate risk

Interest rate risk is the risk that the financial instrument in which the client invests falls in value due to changes in the market interest rate.

3.2.9 Price volatility risk

Price volatility risk is the risk that major fluctuations in the price of a financial instrument will have a negative effect on the investment.

3.2.10 Gearing effect risk

Gearing effect risk is the risk for the price development of the underlying asset to receive a larger negative impact than the price of the derivative instrument.

3.2.11 Tax risk

Tax risk is the risk for unclear or amended tax laws or regulations.

3.2.12 Legal risk

Legal risk is the risk that relevant laws and regulations are vague or may be amended.

4 Trading Systems and Markets

4.1 General information

Trading in financial instruments such as shares, primary capital certificates, bonds, certificates, financial derivative instruments or other rights and obligations that are intended for trading in the securities market, normally takes place in an organized form through a trading system. A trading system means a regulated market, multilateral trading facility (MTF), market making or other liquidity guarantor.

Trading are normally done through the investment firm that uses the relevant trading system. As a client, you must normally contact the investment firm in order to buy or sell financial instrument. There are also investment firms that forward or convey an order to another investment firm that uses the trading system. Trading may also take place internally in an investment firm, for example by the company entering as counter party to the trade, or through trading towards one of the investment firms' clients (internal trading).

Various types of financial instruments are traded on a *regulated market* (including a stock exchange). On the Euronext Exchanges shares, primary capital certificates, bonds, certificates, fund units and a number of different financial derivative instruments are traded. Further information on where and how these instruments are traded, is provided below.

4.2 Regulated Markets

4.2.1 Trading in shares and share related instruments

Only shares issued by a public limited liability company (ASA) or equivalent foreign company may be listed on a regulated market (including a stock exchange) in Norway. In addition, there are requirements to the company's size, operation history, number of owners and publication of the company's finances and other business.

In Norway, there are currently two regulated markets for trading in shares: Oslo Børs and Euronext Expand. The rules are in general the same with regard to following-up, monitoring and sanctioning contraventions of the regulations governing trading in a regulated market. Trading in Norwegian shares may also be done on regulated markets abroad on Multilateral Trading Facilities (MTFs) and foreign stock exchanges.

Trading on a regulated market or other trading systems forms the **secondary market** for already issued shares and bonds. In addition, the OTC list functions as a secondary market for shares. If the secondary market functions well, i.e. it is easy to find buyers and sellers and offer prices from buyers and sellers and the final prices of completed trades are noted continuously, companies benefit from the fact that it is easier to issue new shares and thus raise more capital for the company's activities. The **primary market** is the market where new shares and bonds are purchased/subscribed.

Shares registered on a regulated market or other trading systems are normally divided into various lists depending on the company's market value or liquidity. These lists are often published on the trading system's home page, in newspapers and via other media. The companies listed on Oslo Børs or the Euronext Exchanges in Norway are divided into different indices depending on the company's liquidity, for example the Oslo Børs Benchmark Index and the Oslo Børs Energy Index.

Different shares may demonstrate various levels of stability in their prices (**volatility**) during the day or over longer periods, i.e. the frequency and size by which the prices change. Shares on lists with high liquidity are normally regarded as entailing a lower risk than shares on lists with lower liquidity.

4.2.2 Trading with interest-bearing financial instruments (bonds)

A number of bonds are listed on a stock exchange, so trading in these financial instruments, like trading in listed shares, takes place in a regulated market. In addition, the Oslo Stock Exchange offers an alternative marketplace for trading in bonds and certificates – the **Alternative Bond Market (ABM)**. The Nordic ABM is a separate marketplace that is not regulated by, or subject to a license pursuant to, the Norwegian Stock Exchange Act but is administered and organized by Oslo Børs.

Trading in bonds normally takes place in a different way to trading in shares. In practice, the interest and currency market is regarded as a **quoting or price-driven market**, unlike the stock market which is an order-driven market.

In the case of trading in standardized options, bonds and currency/interest derivatives, the investment firm normally stipulates prices as a market maker and publishes purchase and sales prices based on its own assessments of the market conditions. The market will usually be very transparent, since the prices are published on the investment firm's website or by an information distributor. Clients may thus compare the various investment firms' prices. These prices will either be indicative or binding for a specific volume per transaction. If the prices are indicative, the investment firm will give the client a binding price when the client submits an inquiry to the investment firm. The client is free to accept or reject the investment firm's offer. If the client accepts the price, the investment firm will become the counter party to the transaction.

4.3 Unregulated Markets

Trading in shares that are not listed on a regulated market takes place in the so-called OTC market. In this market, trading takes place to a large extent based on information on prices and interests that the stockbroking firms state to each other. The most commonly used method is for a brokerage firm to enter interests in buying or selling a share in a trading support system which is operated by Oslo Børs. The OTC list is divided into a regular list and a Family and Friends list. Only companies that are registered on the A list must pass price-relevant information of significant importance on to the market. For more information on the OTC list, please see www.notc.no. If a share is not listed on either a regulated market or a trading support system, trading will normally take place by the brokerage firm trying to assist the client by contacting potential clients who may be interested in becoming a contracting party. Investments in this type of share entail a considerable liquidity risk.

4.4 Trading in standardised and non-standardised derivative instruments

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

4.4.1 Standardised derivative instruments

Trading in **standardised** derivative instruments takes place in regulated markets and complies with contracts and conditions which have been standardised by a stock exchange or a clearing organisation. In the Norwegian derivatives market, for example, Oslo Børs offers trading in standardised options and forward/futures contracts.

The following regulated markets in Norway offer trading in standardised derivative instruments:

- **Oslo Børs ASA (Oslo Stock Exchange)** – Trading in standardized options and futures¹
- **Nordpool ASA** – Trading and clearing of physical and financial utility contracts in the Nordic region
- **Nasdaq OMX** – Trading and clearing of commodity derivatives (freight contracts and oil)
- **Fish Pool ASA** – Trading with salmon contracts²

Trading in foreign standardized derivative instruments normally complies with the rules and conditions of the country where the stock exchange trading and clearing are organized. It is important to note that these foreign rules and conditions do not need to be the same as those which apply in Norway.

4.4.2 Non-standardized derivative instruments

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

4.5 Short trading

“Short trading” means to sell financial instruments that one does not own (by borrowing shares from the investment firm or in some other way). At the same time, the borrower undertakes to return instruments of the same type to the lender on a predetermined later date. Short trading is often used as an investment strategy when the share is expected to fall in value. On the sales date, the borrower expects to be able to buy the borrowed instruments in the market on the date when the instruments are to be returned at a lower price than the price at which these instruments were sold. If the price rises instead, the borrower will incur a loss which, in the case of a sharp price rise, may be considerable.

Short-trading requires that the client enters into specific agreements with the investment firm.

4.6 Leveraged (debt financed) trading

Financial instruments can in many cases be bought for partially borrowed capital. Since both the capital invested by the client and the borrowed capital affect the yield, the client may achieve a larger gain through debt financing if the investment develops positively compared to an investment that is made using only the client’s own capital. The debt linked to the borrowed capital is not affected by the prices of the purchased instruments changing in a positive or a negative direction, which is an advantage if prices increase. However, if the price of the purchased instruments falls, this result in a corresponding disadvantage since the debt remains unchanged. In the case of a price fall, therefore, the client’s own invested capital may be lost in whole or in part, while the debt has to be repaid in whole or in part from the revenues from the sale of the financial instruments that have fallen in value. The debt must also be repaid even if the sales revenues do not cover the entire debt.

¹ All trades on Oslo Børs, Euronext Expand and Euronext Growth are cleared by VPS Clearing ASA

² All trades on Fish Pool ASA are cleared by NOS Clearing ASA.

5 Features and Characteristics of Financial Instruments

This chapter contains general information of all financial instruments, its features and characteristics. The following groups of financial instruments are described:

1. Shares and share related instruments (see clause 5.1 below)
2. Interest bearing financial instruments (bonds) (see clause 5.2 below)
3. Derivative Instruments (see clause 5.3 below)
4. Mutual Funds (see clause 5.4 below).

5.1 Shares and share related instruments

5.1.1 General information of shares

5.1.1.1 Shares and limited companies

Shares in limited companies entitle their owner to a proportion of the company's **share capital**. If the company makes a profit, the company usually distributes **dividends** on the shares. Shares also entitle the holders to **vote** at the company's general meeting, which is the highest-ranking decision-making body in the company. Normally, the more shares the holder owns, the greater the shareholder's proportion of the capital, dividends and votes is. Voting rights may vary depending on the class of shares concerned. There are two types of limited companies in Norway, **public limited companies (ASA)** and **private limited companies (AS)**.

5.1.1.2 The share price

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

The **general interest rate level** (the market interest rate) also plays a crucial role in price developments. If the market interest rate increases, interest-bearing financial instruments that are issued at the same time may provide a better return. In such cases, the prices of listed shares normally fall, as will those of already traded interest-bearing instruments with a lower interest rate. The reason for this is that the increasing return on newly issued interest-bearing instruments may be better, relatively speaking, than the return on shares or on already traded interest-bearing instruments. In addition, share prices are negatively affected by the fact that interest payments on the company's debts increase, since this reduces the company's chances of making profits in the future.

Other factors directly related to the company, such as changes in the company's management and organization, disruptions to production etc, may affect the company's future ability to create profits, both in the long- and short-term. In the worst case, a company may perform so poorly that it must be declared **bankrupt**. The share capital, i.e. the capital invested by the shareholders, is that which is repaid last from the estate in bankruptcy. The company's other debts must first be repaid in their entirety. This often results in there being no assets left in the company after its debts have been paid, so that the shares in the company are worthless.

Developments in the prices of financial instruments listed on major **foreign** regulated markets and other trading systems also affect price developments in Norway, among other things because several Norwegian companies are also listed on foreign regulated markets or are traded in other trading systems so that price equalization (arbitrage) takes place between the markets. The prices of shares in companies that belong to

the same industry/sector are often affected by changes in the prices of the shares of other companies within the same industry/sector. This effect may also apply with respect to companies in different countries.

Players in the finance market often have different opinions on how share prices will develop. These factors, which also include how the company will be valued, contribute to there being both buyers and sellers. If the investors share the same opinion regarding price trends, they will either buy, thereby creating buying pressure from many buyers, or sell, thereby creating selling pressure from many sellers. Prices increase in the event of buying pressure and fall in the event of selling pressure.

The **turnover**, i.e. the quantity of a particular share that is bought or sold, affects the share price. In the event of a high turnover, the difference, also called the **spread**, between the price the buyers are prepared to pay (bid price) and the price requested by the sellers (ask price) is reduced. A share with a high turnover, where large amounts can be traded without any major effect on the price, enjoys good **liquidity** and is thus easy to buy or sell. Companies listed on a regulated market, such as Oslo Børs and Euronext Expand, normally enjoy good liquidity.

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

The key figures for the prices at which shares are traded, such as "highest" "lowest" and "latest", as well as information on traded volumes, are published every day, among other places in most major daily newspapers, on teletext and on various Internet sites that are maintained by marketplaces, investment firms and media companies. How current such price information is may vary depending on the manner in which it is published.

5.1.1.3 Various share classes

There are various **classes** of shares, commonly A and B shares, and these are normally of importance to the exercise of voting rights at the company's general meeting. Only a few Norwegian listed companies have different classes of shares. Class A shares normally entitle the holder to one vote, while class B shares normally entitle the holder to a restricted voting right or no voting rights at all. The differences in voting rights may, for example, be due to the fact that, in conjunction with a diversification of ownership, the original founders and the owners of the company have wanted to maintain their influence over the company by holding stronger voting rights.

5.1.1.4 Nominal value, splits and reverse share splits

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

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

5.1.1.5 *Stock Exchange Introduction, privatisation and acquisitions*

A **stock exchange introduction** means that shares in a limited company are listed in a regulated market (including a stock exchange). The general public may then be invited to **subscribe** for (buy) shares in the company. This usually involves an existing company that has not previously been listed on a stock exchange, whose owners have decided to increase the number of shareholders and facilitate trading in the company's shares. If a state-owned company is introduced on the stock exchange, this is called **privatisation** or part-privatisation, depending on the size of the stake in the company that the state is offering to sell to the general public.

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

5.1.1.6 *Share Issues*

If a limited company wishes to expand its operations, additional capital is often required. The company raises this by issuing new shares through a **share issue**. The existing shareholders usually receive **subscription rights** giving them a pre-emptive right to subscribe for shares in the new issue. The number of shares that may be subscribed for is established in relation to the number of shares previously held by the shareholder. The subscriber must pay a price (issue price) for the newly issued shares that is often lower than the market price. Immediately after the subscription rights - which normally have a certain market value - are detached from the shares, the price of the shares normally declines. Shareholders that have subscription rights but do not subscribe for shares may sell their subscription rights in the marketplace where the shares are listed during the subscription period (which often lasts for a few weeks). Once the subscription period has ended and the shares have been allocated, the subscription rights lapse and thus become useless and worthless.

If the share premium account in a limited company has greatly increased in value, the company can transfer part of the value to its shareholders through what is commonly referred to as a **bonus issue**. In a bonus issue, consideration is given to the number of shares already held by each shareholder. The number of new shares offered to the shareholders through the bonus issue is established in proportion to the number of shares the shareholder already holds. Through the bonus issue, the shareholder receives more shares but the shareholder's proportion of the company's share capital remains unchanged. The price of the shares falls in conjunction with a bonus issue but, through the increase in the number of shares, the value of the shareholder's invested capital remains unchanged.

A limited company can also carry out a so-called **private placement**, which is carried out as a share issue but is directed solely at a limited group of investors. In a private placement, the existing shareholders' proportion of the shares and share capital in the company is **diluted**, but the number of owned shares is not affected and the market value of the invested capital is also not normally affected.

5.1.2 **General information share-related instruments**

Primary capital certificates, convertible bonds/debentures, share-index bonds/index bonds, warrants, share options, share-index options and depository receipts are closely related to shares. These instruments are normally traded in a regulated market (including a stock exchange) but are also traded in the OTC market.

5.1.2.1 *Primary Capital Certificates*

Primary capital certificates are very similar to shares. The difference is primarily related to the ownership of the company's assets and influence over the issuer's corporate bodies. There are also some restrictions on the distribution of dividend. The listed primary capital certificates in Norway are issued by savings banks. More information on primary capital certificates is available at www.grunnfondsbevis.no.

5.1.2.2 Convertible bonds

Convertible bonds are interest-bearing securities which may be exchanged for shares within a certain period of time. The return on the convertible bonds, ie, the coupon interest, is normally higher than the dividend on the shares to be received in exchange. The price of convertible bonds normally follows the share price and is expressed as a percentage of the nominal value of the convertible bond.

5.1.2.3 Share-index bonds/index bonds

Share-index bonds/index bonds are bonds whose yield normally depends on how a share index develops. If the index develops positively, so does the return. In the event of a decline in the index, there may be no return. However, the nominal value of the bond is always repaid on the maturity date so the risk of loss is limited compared to shares and fund units. Apart from any share premium, the risk of investing in a share-index bond may be defined as the alternative interest income, ie, the interest the investment could have achieved if the amount had been invested differently.

5.1.2.4 Warrants

Certain call (purchase) and put (sales) options with a longer term to maturity than the standardised call options, normally called **warrants**, are also traded. Warrants may be used to buy underlying shares or to provide a cash settlement if a gain has been achieved as a result of the price of the underlying share being higher than the agreed future purchase price/selling price.

5.1.2.5 Share Options and share-index options

There are various types of **share options**. Acquired (bought) purchase options (call options) entitle the owner to purchase already issued shares at a predetermined price within a specific period of time. Acquired (bought) sales options (put options) entitle the holder to sell shares at a predetermined price within a specific period of time. There is an **issued/written** (sold) option corresponding to each **acquired** option. The risk borne by the party that acquires an option is that the option will decline in value or become worthless by the expiry date. Unless special precautionary measures are taken, the issuer (writer) of an option runs a risk which may be unlimited in scope.

Index options produce a gain or loss linked to the development of the underlying index. The price of options (premium/price) normally follows the developments in the price of the corresponding underlying shares or index.

5.1.2.6 Depository Receipts

Depository receipts are proof that shares are stored by a depository and give the owner the same rights as if he/she owned the actual share. Depository receipts are traded as shares and their prices normally follow the price trends in the foreign regulated market where the share is traded.

5.2 Interest-bearing Financial Instruments (Bonds)

5.2.1 General information interest-bearing financial instruments (bonds)

An interest-bearing financial instrument is a **right to claim** against the issuer of a loan. The return is normally provided in the form of **interest (coupon)**. There are various types of interest-bearing instruments depending on the issuer of the instrument, the **security** provided for the loan by the issuer, the **term until the maturity date**, and how interest is paid.

The interest (coupon) is normally paid as a fixed or floating rate. For fixed-interest loans, the interest is normally stipulated (fixed) for one year at a time. For floating-interest loans, the interest is normally stipulated (fixed) four times a year for three months at a time based on the NIBOR interest rate. On certain types of loans, no interest is payable and only the nominal amount is repaid on the loan's maturity date (zero coupons). The purchase of zero coupon bonds takes place at a considerable discount, which means that the effective interest rate is the same as for bonds on which a regular coupon interest is paid. For example, all

the debts that the Norwegian state issues in Treasury bills (government certificates) are zero coupon instruments.

The **risk** associated with an interest-bearing instrument consists in part of the price changes that may occur during the term of the instrument due to changes in market interest rates, and in part that the issuer may be unable to repay the loan. Loans for which satisfactory security has been provided for repayment are thus less risky than loans without security. However, in purely general terms, it can be stated that the risk of loss associated with interest-bearing instruments may be deemed lower than it is for shares.

Market interest rates are established every day both for instruments with short terms until maturity (less than one year), e.g. **certificates**, and for instruments with longer terms until maturity, such as **bonds**. This takes place in the money market and bond market. Market interest rates are affected by analyses and assessments conducted by the Central Bank of Norway and other major institutional market players with regard to short-term and long-term trends in a number of economic factors, such as inflation, the state of the economy, and interest rate changes in Norway and other countries. The Central Bank of Norway also conducts operations in the money market and currency market with the aim of controlling changes in the market interest rate so that inflation does not exceed or fall below an established target.

If the market interest rate increases, the price of already issued interest-bearing financial instruments will fall if they provide a fixed interest rate. This is because new bonds are issued bearing rates of interest that follow the current market rate of interest and thereby provide a higher rate of interest than the already issued instruments. Conversely, the price of already issued instruments increases when the market interest rate declines.

Bonds issued by the State, county council and municipalities (or guaranteed by such bodies) are deemed to be more or less risk-free with respect to redemption at the predetermined value on the due date.

5.3 Derivative instruments

The principal types of derivative instruments are options, forwards/future contracts and swap-agreements.

5.3.1 General information of derivative instruments

A derivative instrument is a form of agreement (contract) where the agreement itself is traded on the financial instruments market. The derivative instrument is linked to an underlying asset or an underlying value. This asset or value (described below simply as an asset) can be comprised of another financial instrument, another asset with a financial value (for example, a currency or commodity), or some form of value indicator (such as an index). Derivative instruments can be used to create a hedge against an anticipated unfavorable price development in the underlying asset. They can also be used to achieve a profit or yield with a smaller capital investment than would be required in order to trade directly in the underlying asset. Derivative instruments can also be used for other purposes. The use of derivative instruments is based on a certain expectation as to how the price of the underlying asset will develop over a certain period of time. Before starting to trade in derivative instruments, it is therefore important that the client is clear in his/her own mind as to the intended purpose and the price developments in the underlying asset that can be expected and, on that basis, chooses the right derivative instrument or combination of such instruments.

5.3.2 General information of options

An **option** is a contract which involves one party (the issuer (writer) of the option contract) undertaking to buy or sell the underlying asset to the other party (the holder of the contract) at a predetermined price (the exercise price). The date when the holder can exercise the right may depend on the type of option in question. An **American option** may be exercised at any time during the maturity period while a **European option** may only be exercised on the expiry date. The holder pays a premium to the writer and is then entitled to exercise the rights stated in the contract but has no obligation to do so. The writer, however, is obliged to fulfill the contract if the holder so wishes. The price of the option normally follows the price of the

underlying asset. The risk run by the party buying an option is that it will be reduced in value or be worthless by the expiry date. The writer of an option runs a risk which, unless special precautions are taken, may be unlimited.

5.3.2.1 Options with variable strike price

This is in principle a forward/futures contract but the margin security is paid in the form of an option premium. In addition to the purchase of an American call option, the purchase of the product includes the sale of a European put option with the same strike price. The European put option lapses if the call option is exercised or closed out. In addition, the product contains an option for the seller, in the case of a specified fall in the price of the underlying financial instrument, to demand the closing out of the option in return for the simultaneous issuance of a new option with a lower strike price and correspondingly higher premium.

5.3.2.2 Index option/Index futures contract

A contract where the underlying asset is an index value, not a security. Such a contract is settled not by delivering financial instruments but by calculating the contract's value in money.

5.3.2.3 Call options

The **buyer** of a call (purchase) option obtains a **right** to buy an underlying asset at a future date at a predetermined price. The buyer of a call option pays an option premium and costs related to selling and administering the option contract.

The maximum amount the holder of a call option can lose is limited to the option premium and the costs paid. The maximum loss arises when the price of the underlying financial instrument remains lower than or equal to the exercise (strike) price.

The potential for gain is in theory unlimited. The gain is the value of the underlying financial instruments on the exercise date minus the strike price and option premium including costs.

The **writer/seller** of a call option incurs a **duty** to sell (if the option holder so requires and buys) the underlying assets at a future date at a predetermined price. The seller of a call option receives an option premium minus costs relating to selling and administering the option contract.

The potential for gain on the issuance of a call option is limited to the net option premium. If the strike price remains higher than or equal to the market price of the underlying financial instrument, the writer is allowed to keep the option premium without the holder normally demanding to be allowed to buy the securities.

If the writer has hedged his/her interests by owning the underlying financial instruments, the writer does not incur a loss if the price rises but misses out on the increase in value in excess of the option premium. In the case of a fall in price, the writer incurs a loss if the price of the underlying security falls below the cost price of the security minus the option premium received.

If the writer has not hedged his/her interests by owning the underlying financial instruments, he/she has an unlimited loss potential if the price rises. If the holder demands to exercise the option, the writer must buy the financial instruments in the market at the market price. The loss is calculated as the market value of the underlying financial instruments minus the strike price and option premium.

5.3.2.4 Put options

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

The maximum amount that the holder of a put option can lose is limited to the option premium and the costs paid. The maximum loss arises when the price of the underlying financial instrument remains higher than or equal to the strike price.

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

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

The potential for gain on the issuance of a put option is limited to the net option premium. If the strike price remains lower than or equal to the price of the underlying financial instrument, the writer is allowed to keep the option premium without the holder normally demanding to be allowed to sell the securities.

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

5.3.2.5 Forward/Futures contracts

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

No premiums are paid for forward/futures contracts but the agreed forward/futures price will normally be stipulated to be the spot price (the current market price) of the underlying financial instrument plus interest costs until the forward/futures settlement date. In addition, the costs of trading and administering the forward/futures contract must be paid.

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

A **seller that owns** the underlying financial instruments bears no risk relating to developments in the price of the underlying financial instrument, he/she only runs a credit risk related to the buyer being able to settle the agreed amount on the settlement date.

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

5.3.2.6 Swap-agreements

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

A **price swap agreement** is a contract that, from a risk point of view, is completely equivalent to a forward/futures contract but where the underlying financial instruments are not to be delivered on the expiry date. On the expiry date, a monetary settlement is carried out based on the difference between the swap price and the market price on the expiry date.

A **Securities swap agreement** is a combination of (at least) two financial instruments, in which a party buys one instrument (the long position) and sells the other short (the short position).

5.3.3 Characteristics of derivative instruments

Trading in derivative instruments can be described as trading in, or the transfer of, risk. For example, a party that expects prices to fall in the market can buy put (sell) options which increase in value if the market falls. In order to reduce or avoid the risk involved in a fall in price, the buyer pays a premium, i.e. what the option costs. Trading in derivatives is in many cases not advisable for clients with little or limited experience of trading in financial instruments, since such trading often requires specialized knowledge. It is important that those intending to trade in derivative instruments are aware of the following characteristic properties of these instruments.

The structure of derivative instruments is such that the price developments in the underlying asset are reflected in the price of the derivative instrument. The change in price is often greater in relation to the amount invested than the change in the value of the underlying asset. The change in price is therefore referred to as a leverage/gearing effect and can lead to a larger profit on the invested capital than if the investment had been made directly in the underlying asset. On the other hand, the leverage effect may result in a greater loss on the derivative instrument compared to the change in value of the underlying asset if the price of the underlying asset develops differently to that expected. The leverage effect, i.e. the possibility of making a profit or risk of suffering a loss, varies depending on the derivative instrument's structure and scope. Monitoring the price developments in the derivative and underlying asset is therefore of the utmost importance. The client should, in his/her own interests, be prepared to act swiftly, often that same day, should the derivative instrument start developing in an unfavorable direction.

A party that assumes an obligation by writing an option or entering into a futures contract is required to provide collateral for his/her position from the outset. The collateral requirements vary in step with upward or downward movements in the price of the underlying asset that lead to the value of the derivative instrument increasing or decreasing. Further security in the shape of supplementary collateral may therefore be required. Thus, the leverage effect also has an impact on the collateral requirement, which can change quickly and radically. If the client fails to provide enough collateral, the clearing organization or investment firm is entitled to terminate the placement (close out the position), without the client's permission, in order to reduce the loss. Clients should therefore carefully monitor price developments and collateral requirements in order to prevent an unwanted closing out of their positions.

The maturity period for derivative instruments can vary from a very short period to up to several years. The relative price changes are often greatest for instruments with a short (remaining) maturity period. The price of a held option, for example, generally decreases more and more quickly towards the end of the maturity period due to the fact that the time value decreases. Clients should therefore carefully monitor the maturity periods of their derivative instruments as well.

5.4 Mutual Funds

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

Below is a brief description of the most common mutual funds:

Unit trust/equity fund: a mutual fund that must normally invest at least 80 per cent of its total assets in shares (or other equity instruments) and which must normally not invest in interest-bearing securities.

Combination fund: a mutual fund that is not defined as a pure unit trust/equity fund or interest fund. A combination fund may have a more or less permanent preponderance of shares or interest-bearing securities, but the proportion of various securities may also change during the fund's lifetime.

Interest funds: a mutual fund that is to invest in securities other than shares. These funds are divided into bond funds and money market funds.

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

Fund of funds: a mutual fund that invests in one (or possibly more) underlying mutual funds.

Hedge funds (specialist funds): there is no exact definition of the concept of a hedge fund, and individual hedge funds may vary greatly as regards investment choices and risk profiles. A hedge fund normally takes much more risks than a normal mutual fund and is therefore a product for professional investors that are willing to accept a large amount of risk. A hedge fund does not have to comply with the Norwegian Mutual Funds Act or the UCITS Directive and is free to use various financial instruments. The fund can usually raise loans and is normally quite free to use various derivatives. A hedge fund can also trade "short" in securities, which means that the fund sells borrowed securities and then buys the borrowed securities at a later date.

When they invest in a fund, unit holders receive the number of units in the fund that equals their invested capital's percentage of the fund's total assets under management.

The units may be bought from and redeemed (sold) to the management company. The units' actual value is calculated daily by the management company and is based on developments in the prices of the financial instruments in which the fund has invested. There are also fund units that can be traded in a regulated market (**Exchange Traded Funds** ("ETF")).

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

For more information on mutual funds, visit www.vpff.no.
