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1. General Information

- (a) A derivative is a financial instrument, the value of which is derived from an underlying asset's value. Rather than trade or exchange the asset itself, an agreement is entered into to exchange money, assets or some other value at some future date based on the underlying asset. A premium may also be payable in order to acquire the derivative instrument.
- (b) Clients should not deal in derivative products unless these thoroughly understand the nature of the contract they are entering into and the extent of their exposure to risk. Clients should also be satisfied that the contract is suitable for them in the light of their circumstances and financial position.
- (c) An investor in derivatives often assumes a high level of risk, even where the intention behind entering to a derivative is to reduce risk by way of hedging, and therefore investments in derivatives

should be made with caution, especially for less experienced investors or investors with a limited amount of capital to invest.

- (d) If a derivative transaction is particularly large or if the relevant market is illiquid (as may be the case with many privately negotiated off-exchange derivatives), it may not be possible to initiate a transaction or to liquidate a position at an advantageous price.
- (e) Off-exchange derivatives may take the form of unlisted transferable securities or bilateral “over-the-counter” contracts (“**OTC**”). Although these forms of derivatives may be traded differently, both arrangements may be subject to credit risk of the issuer (if, as the case may be, transferable securities) or the counterparty (if OTCs) and, like any contract, are subject also to the particular terms of the agreement (whether a one-off transferable security or OTC contract, or a master agreement), as well as the risks identified below. In particular, with an OTC agreement, the counterparty may not be bound to “close out” or liquidate this position, and so it may not be possible to terminate a loss-making contract. Off-exchange derivatives are individually negotiated. As the terms of the transactions are not standardized and no centralized pricing source exists (as exists for exchange traded instruments), the transactions may be difficult to value. Different pricing formulas and financial assumptions may yield different values, and different financial institutions may quote different prices for the same transaction.
- (f) Derivatives may be used for speculative purposes or as hedges to manage other investment or economic risks. In all cases the suitability of the transaction for the particular investor should be very carefully considered.
- (g) Clients are, thus, advised to ask about the terms and conditions of the specific derivatives and associated obligations (v.gr. the circumstances under which Clients may become obligated to make or take delivery of an underlying asset and, in respect of options, expiration dates and restrictions on the time for exercise). Under certain conditions the specifications of outstanding contracts (including the exercise price of an option) may be modified by the exchange or clearing house to reflect changes in the underlying asset. Normal pricing relationships between the underlying asset and the derivative may not exist in all cases. This can occur when, for example, the futures contract underlying the option is subject to price limits while the option is not. The absence of an underlying reference price may make it difficult to assess ‘fair’ value.

2. Contingent liability transactions

- (a) Contingent liability transactions, which require the provision of collateral, require Clients to make a series of payments against the purchase price, instead of paying the whole purchase price immediately.
- (b) If Clients trade in futures, contracts for differences or sell options these may sustain a total loss of the collateral Clients deposit with their relevant firm to establish or maintain a position. If the market moves against Clients, the latter may be called upon to pay substantial additional collateral at short notice to maintain the position. If the Clients fail to do so within the time required, their position may be liquidated at a loss and the Clients will be responsible for the resulting deficit.
- (c) Even if a transaction does not require collateral/security, it may still carry an obligation to make further payments in certain circumstances over and above any amount paid when the Clients entered the contract.

3. Options

- (a) An option is a derivative which gives the holder, in exchange for the payment of a premium, the option to purchase (which is referred to as a call option) or to sell (which is referred to as a put option) an underlying asset. There are several option styles including (but not limited to) American-, European- and Bermuda-style. An American-style option may be exercised at any time prior to its expiration. A European-style option may only be exercised on a specific date, its expiration date. A Bermuda-style option may be exercised on certain specified dates during the term of the transaction.
- (b) Purchasing options involves less risk than selling options because, if the price of the underlying asset moves against Clients, the latter can simply allow the option to lapse. The maximum loss is limited to the premium, plus any commission or other transaction charges. If Clients write (sell) an option, the risk involved is considerably greater than buying options. Clients may be liable for collateral to maintain their position and a loss may be sustained well in excess of the premium received. By writing an option, the Clients accept a legal obligation to purchase or sell the underlying asset if the option is exercised against the Clients, however far the market price has moved away from the exercise price. If the Clients already own the underlying asset which they have contracted to sell (when the options will be known as “covered options”) the risk is reduced. If the Clients do not own the underlying asset (“uncovered options”) the risk can be unlimited. Only experienced persons should contemplate writing uncovered options, and then only after securing full details of the applicable conditions and potential risk exposure.
- (c) Certain London Stock Exchange (“LSE”) member firms under special LSE rules write a particular type of option called a ‘traditional option’. These may involve greater risk than other options. Two-way prices are not usually quoted and there is no access to a market on which to close out an open position or to effect an equal and opposite transaction to reverse an open position. It may be difficult to assess its value or for the seller of such an option to manage his exposure to risk.
- (d) Certain options markets operate on a collateralized basis, under which buyers do not pay the full premium on their option at the time they purchase it. In this situation Clients may subsequently be called upon to pay collateral on the option up to the level of their premium. If the Clients fail to do so as required, their position may be closed or liquidated.
- (e) Depending on the type of option entered into, there may be increased exposure to market risk when compared to other financial products. If the Clients buy an American-style option and the relevant market price of the underlying asset never increases above the strike price on the option (or if the Clients fail to exercise the option while such condition exists), the option will expire unexercised, and the Clients will have lost the premium these paid for the option. Purchasing European-style or Bermuda-style options may carry additional market risk since the option could be “in-the-money” for part or substantially all of the holding period but not on the exercise date(s).
- (f) It is even possible for the holder of an exercised, “in-the-money” option to lose money on an option transaction. Such a situation exists whenever the value received under the option fails to exceed the purchaser’s costs of entering into the option transaction (the premium and any other costs and expenses).
- (g) If the Clients are a potential writer of an option, they should consider how the type of option affects the timing of their potential payment and delivery obligations thereunder. As the writer of a European-style option, the timing of any payment and delivery is predictable. Absent early termination, no settlements will be necessary prior to the expiration date. As the writer of an

American-style option, however, the Clients must be certain that they are prepared to satisfy their potential payment and delivery obligations at any time during the exercise period (possibly quite soon following the sale of the option).

4. Futures

- (a) Transactions in futures involve the obligation to make, or to take, delivery of the underlying asset of the contract at a future date, or in some scenarios to settle the position in cash. These carry a high degree of risk. The 'gearing' or 'leverage' often obtainable in futures trading means that a small deposit or down payment can lead to large losses as well as gains. It also means that a relatively small movement can lead to a proportionately much larger movement in the value of their investment, and this can work both against and for the Clients.
- (b) Futures transactions have a contingent liability, and the Clients should be aware of the implications of this, in particular collateralization requirements: these are that, on a daily basis, with all exchange-traded futures, the Clients will have to pay over in cash losses incurred on a daily basis and if the Clients fail, the contract may be terminated.

5. Forwards

- (a) Transactions in forwards provide for an equal degree of risks as futures, as these also involve the obligation to make or take delivery of an underlying asset, but they involve a higher counterparty default risk as they are typically traded OTC off-exchange. They are also less likely to be closed out prior to maturity, meaning that the Clients are less able to take advantage of fluctuations in asset prices by selling the forward in the market.

6. Swaps

- (a) A swap agreement is a derivative where two counterparties exchange one stream of cash flows (generally fixed at the strike price) against another stream, calculated by reference to an "underlying" (such as securities' indices, bonds currencies, interest rates or commodities, or more intangible items).
- (b) The key risk associated with swaps is where the price of the underlying moves significantly away from the strike price of the swap. Where, for example, one counterparty pays a fixed rate of 5% and the other counterparty pays a floating rate by reference to Bank of England base rate, and the Bank of England base rate falls to 1% or lower, the counterparty paying the fixed rate is well "out-of-the money" and owes much more than it would if it did not enter into the swap. A counterparty being out of the money may also be seen as a higher credit risk as its outstanding liabilities are higher than they would otherwise be, affecting that counterparty's other transactions.
- (c) Counterparty insolvency risk can affect swaps significantly: for example if a party, A, wants a fixed interest rate loan and so swaps a variable rate loan with another party, B, thereby swapping payments, this will synthetically create a fixed rate for A. However, if B goes insolvent, A will lose its fixed rate and will be paying a variable rate again. If interest rates have gone up a lot, it is possible that A will struggle to repay.

7. Caps

- (a) A resembles a swap except that the fixed stream is only fixed once the price of the underlying reaches a certain upper limit. Until that point (and after it reduces under the limit) both counterparties pay each other at the price of the underlying.

- (b) A cap is less risky than a swap for a counterparty paying the fixed price as it can take advantage of reductions in the price of the underlying, while being protected from certain increases in the price. However, it is riskier for the other counterparty, as the other counterparty will not be able to take advantage of the price going down (as the other party will pay the same rate) but will have to absorb the higher price where it goes above the cap.
- (c) To make up for this risk, the counterparty paying the fixed price will often pay a premium. Due to the inherent uncertainties of calculating the value of this risk, the premium may be higher than the counterparty paying it would pay in total under a swap.

8. Floors

- (a) A floor is similar to a cap except that the fixed stream is fixed once the price of the underlying reaches a lower limit. It presents similar risks to a cap for both parties except that the risks apply to the opposite parties compared to a cap.

9. Collars

- (a) A collar is a combination of a cap and a floor, in that the fixed stream is only fixed where the price of the underlying either reaches an upper limit or a lower limit. As such, it presents the same risks as a cap or a floor to both parties depending on the price of the underlying at any given time.
- (b) While a premium is often payable in respect of a collar, one or other of the parties may also agree to mitigate their risks by changing the value of the fixed stream from (as would normally be the case under a floor) the value of the lower limit to a higher value. For example, an interest rate collar may stipulate that where base rate is 5% or lower a party pays 5.5%, where it is between 5% and 7% the party pays base rate, and where it is 7% or higher the party pays 7%. There may even be an intermediate stipulation where if, for example, base rate is between 5.5% and 6.5%, the party pays 6%. These variations are all ways of mitigating risks for each party, but a party entering into such an inherently complex instrument should consider the benefits of the instrument as compared to the position if it does not enter into the instrument at all, as it may have unanticipated adverse consequences.

10. Swaptions

- (a) Swaptions are transactions that give the purchaser of the swaption the right, against payment of a premium, to exercise or not to exercise, until the agreed maturity date, its right to enter into a preagreed swap agreement. It therefore combines the risks of options and swaps. The risks of entering into a swap are exacerbated by the fact that only the pre-existing swap may be entered into under the option, so if there is a more advantageous swap available it cannot be entered into and the premium paid for the option will be lost.

11. Spread Options

- (a) Spread options are options that are valued on the basis of the difference between the price of two or more assets. The underlying assets can be any type of assets including equities, bonds and currencies. The value of the spread option is therefore determined by the volatility and risk exposures of the underlying assets. A spread option will have all of the risks associated with other options, but the risks are compounded by dependence on the two separate variables instead of solely one. Spread options are also likely to be traded OTC rather than on an exchange, which carries greater counterparty default risk.

12. Commodity Derivatives

- (a) Where the value of a derivative is linked to the price of a commodity, the extra volatility of commodity prices, as compared with other prices, may compound the risks of the derivatives. In particular, the risks associated with being “out-of-the-money” are greater as a counterparty may be significantly more “out-of-the-money” than it is likely to be with derivatives based on a different underlying.

13. Credit Derivatives

- (a) Credit derivatives are derivatives which are intended to transfer credit risk. The price is determined by the credit risk of the relevant borrower. A typical credit derivative will involve the transfer of the risk to a third party (as counterparty to the credit derivative) such that the third party will (in exchange for a fee) pay the outstanding liabilities of the borrower in the place of the borrower. As with other forms of derivative, credit derivatives are exposed to market risk, counterparty risk and liquidity risk, but in addition to the normal counterparty risk, parties entering into credit derivatives are exposed to the risk of the borrower. As the price of the credit derivative is dependent on this risk, the accuracy of the valuation of the credit derivative is difficult to determine, and the price paid for the derivative may be higher than the risk of borrower default. Credit derivatives may also create systemic risks in that certain market participants may assess risk less accurately because they can pass risk onto third parties under the credit derivative.

14. Non-Deliverable Forwards

- (a) Non-deliverable forwards are forward contracts in foreign currency where, unlike a normal forward, no currency is actually purchased on the forward's maturity date. Instead, the forward is cash settled on the basis of the difference between the agreed exchange rate in the forward and the actual spot rate at the maturity date. Non-deliverable forwards are typically used in relation to non-convertible foreign currency where a normal forward is not possible because certain governments prohibit forward trading in their currency.
- (b) Non-deliverable forwards carry lower counterparty risk as instead of needing to pay the full amount for actual foreign currency, parties to a non-deliverable forward are only required to pay the difference between the agreed forward rate and the actual spot rate. However, in addition to normal derivatives risks, these carry risks associated with valuing the payment on the maturity date. This is because, unlike a normal foreign exchange forward where the exchange happens according to the applicable spot rate at the time (and one party bears the profit or loss on that exchange compared to the forward rate), in a non-deliverable forward the currency is not actually exchanged, and so a spot rate has to be derived from market indicators and quotes. This is inherently less certain and therefore riskier.

15. Asset Swaps

- (a) Asset swaps are a category of swaps that are based on underlying exchange of fixed income and non-fixed income investments rather than cash flows. The intention is that the fixed income investment (such as a bond) will pay out what would in a normal swap be the fixed cash flow while the other investment will pay out the floating cash flow. In addition to the risks generally presented by swaps, therefore, counterparties to an asset swap will be subject to all of the risks associated with financial instruments such as bonds, including default risk associated with the issuer of the bond.

16. Forward Rate Agreements

- (a) A forward rate agreement is an agreement which determines the interest rate or currency exchange to be paid or received on an obligation beginning in the future. They therefore carry all of the risks associated with futures or forwards, in that they commit the parties to a particular price which may be significantly different and less advantageous than the market price, as well as the additional disadvantage that the rate is paid on a sum also pre-determined and set in the future. A counterparty may therefore end up being “out of the money” twice – first as regards the sum to be paid and second as regards the rate.

17. Repos

- (a) Repos (and stock lending) are not strictly derivatives but are often grouped with them as they have some similar structural features.
- (b) The term repo refers to a sale and repurchase transaction in securities, normally fixed income securities such as bonds. In a repo, the repo seller transfers title in the securities to the repo purchaser. The repo is in effect for a specific period, and at the end of the period the repo purchaser transfers title to equivalent securities (of the same issuer and type) to the repo seller.
- (c) The repo purchaser's obligation to transfer equivalent securities is secured against collateral (usually under a Title Transfer Collateral Arrangement). There is, accordingly, credit risk. Selling securities under a repo may also affect the Clients' tax position (although the Clients should seek independent advice on the issue).
- (d) As a result of selling securities under a repo the Clients will cease to be the owner of them, although Clients will have the right to reacquire at a future date equivalent securities (or in certain circumstances their cash value or the proceeds of redemption). However, except to the extent that the Clients have received collateral, their right to the repurchase of securities is subject to the risk of insolvency or other non-performance by the borrower. Since the Clients are not the owner of the securities during the period of the repo, the Clients will not have voting rights nor will the Clients directly receive dividends or other corporate actions although the Clients will normally be entitled to a payment from the repo purchaser equivalent to the dividend the Clients would otherwise have received and the repo purchaser will be required to account for the Clients for the benefit of corporate actions.
- (e) Repos also entail counterparty default risk and operational risks such as the non-settlement or delay in settlement of instructions.

18. Stock Lending

- (a) Stock lending (or securities lending) agreements are very similar to repos in structure. Although the terminology is different (referring to lender and borrower as opposed to seller and purchaser) securities are not “lent” but are in fact fully legally transferred. The risks are therefore broadly similar in terms of losing rights over securities transferred and, in particular, being subject to counterparty default risk.
- (b) A key difference is that repos generally use fixed income products whereas stock lending uses equities. Equities can often be riskier for the party that holds them than fixed income products as what they pay can fluctuate significantly. However, stock lending agreements normally require any payments to be transferred to the lender, so the risks of lower payments transfer to the lender rather than to the borrower. Whereas most repo takes place so that the seller can obtain cash,

stock lending is driven by the borrower who wants to hold the securities for a particular time. The borrower will therefore need to consider carefully the reasons it has for holding the securities under a stock lending agreement.