

FINANCIAL INSTRUMENTS - THEIR CHARACTERISTICS AND THE RISKS INVOLVED IN TRADING IN THEM

(SHARES, OTHER SHARE-RELATED INSTRUMENTS, BONDS AND SECURITIES FUNDS)

Clients need to know that:

- trading in financial instruments takes place at clients' own risk
- before starting to trade in financial instruments, clients need to familiarise themselves thoroughly with the firm's general terms and conditions of business and other relevant information about the characteristics and risks involved in the specific financial instrument
- clients must check contract notes immediately and complain straight away if any errors are found
- clients should continuously monitor price changes in the financial instruments in which they have positions
- if necessary, clients must react by selling their positions in order to reduce the risk of loss

1. TRADING IN FINANCIAL INSTRUMENTS

Trading in financial instruments such as shares, primary capital certificates, bonds, treasury bills, financial derivative instruments or other rights and obligations designed to be traded in the securities market, normally takes place in an organised form in a **trading system**. 'Trading system'¹ means a regulated market, multilateral trading facility (MTF)², systematic internaliser (SI)³, market maker⁴ or other liquidity guarantor.

Trading is carried out through the securities firms that use the trading system. A client must normally contact a securities firm in order to buy or sell financial instruments. There are also securities firms that transmit orders to other securities firms that in turn use the trading system. Trading may also take place internally within a securities firm, for example by the firm stepping in as counterparty in a trade, or by trading with another of the firm's clients (internal trading).

Various types of financial instrument are traded on a **regulated market** (including stock exchanges). Shares, primary capital certificates, bonds, treasury bills, certain fund units and a number of different financial derivatives are traded on the Oslo Børs (Stock Exchange). Where and how these instruments are traded is discussed in more detail below.

Price information about the financial instruments that are traded on the regulated market is published regularly on their websites, in newspapers and in other media.

1 Securities Trading Regulations s. 10-25 (2).

2 Securities Trading Act s. 2-3 (4) – MTF do not exist in Norway at present.

3 Securities Trading Act s. 2-4 (4) – SI do not exist in Norway at present.

4 Securities Trading Act § 2-4 (4) – Several securities firms act as liquidity guarantor for selected companies.

2. RISKS ASSOCIATED WITH TRADING IN FINANCIAL INSTRUMENTS

2.1 General information about risk

Financial instruments normally provide *returns* in the form of *dividends* (shares and units in securities funds) or *interest* (interest-bearing instruments). The price of the instrument may also increase or decrease in relation to the price paid when the investment was made. In the description below, the word “investment” is also used in the context of any negative positions in the instrument (short position, see Section 7 below). The total return is the sum of dividends/interest and the change in the price of the instrument.

The investor is naturally looking for a total return that is positive, i.e. it results in a *gain*. But there is also a *risk* that the total return will be negative i.e. the investment results in a *loss*. The risk of loss varies between different instruments. Usually, the chance of a gain on an investment in a financial instrument is linked to the risk of a loss. The longer the time perspective for the investment, the greater the chance of gain or loss. The word “risk” is often used in the context of a placement to express both the risk of loss and opportunity for gain. However, in the description below “risk” is only used to describe the risk of loss. To reduce the risk, there are various ways of investing in financial instruments. It is usually better from a risk point of view to invest in several different financial instruments than in a single one or just a few. These instruments should then have characteristics that involve *a spread of risk*, rather than being concentrated so that they may be triggered simultaneously. When trading in foreign financial instruments there is also a *currency risk*.

Investing in financial instruments carries a *financial risk*, which will be described in more detail below. The client is personally responsible for this risk and must therefore learn about the conditions, prospectuses etc. that apply when trading in these instruments and about the special risks and characteristics of the instruments. Clients must also monitor their investments in financial instruments on an ongoing basis. This applies even if the client has received individual advice about the investment. Clients may monitor prices, and thus the performance of their own investments, in the exchange lists published in the mass media, for example newspapers, the Internet and TV text services. In some cases, information may be available from the securities firm itself. If necessary, clients should react quickly in their own interests, for example by disposing of investments showing negative trends, or by providing additional security where investments are financed by loans and the security value is declining.

2.2 Different risk concepts

There are many different types of risk and other factors that clients ought to be aware of when carrying out the initial and ongoing risk assessments which every investor should undertake throughout the investment period, when investing and trading in financial instruments.

Some of the most important types of risk are as follows:

Market risk - the risk of a fall in the market in its entirety, or certain parts of the market where the client has invested (for example, the Norwegian Stock Market).

Credit risk - the risk of an issuer or counterparty having reduced ability to pay.

Price volatility risk - the risk of large fluctuations in the price of a financial instrument having a negative effect on the investment.

Price risk - the risk that the price of a financial instrument will fall.

Taxation risk - the risk that taxation rules and/or rates are unclear or can be changed.

Currency risk - the risk of a foreign currency linked to the investment falling in value (for example certain units in a securities fund might be placed in American securities listed in USD).

Gearing effect risk - the construction of a derivative instrument means that there is a risk of price movements in the underlying asset having a greater negative effect on the price of the derivative instrument.

Legal risk - the risk that relevant laws and regulations are unclear or may be changed.

Company-specific risk - the risk that a company performs worse than expected or that it is the victim of a negative event, causing the financial instruments associated with the company to fall in value.

Industry-specific risk - the risk that a particular industry performs worse than expected or is the victim of a negative event, causing the value of the financial instruments associated with the industry concerned to fall in value.

Liquidity risk - the risk of the client not being able to sell a financial instrument at the time the client wishes to do so, because market turnover and buyer interest in the financial instrument are low.

Interest rate risk - the risk that the financial instrument in which the client is investing falls in value because of changes in the market rate of interest.

3. SHARES AND OTHER SHARE-RELATED INSTRUMENTS

3.1 General information about shares

3.1.1 Shares and limited companies

Shares in a limited company give the owner the right to part of the company's *share capital*. If the company generates profits, the company normally pays *dividends* on the shares. Shares also carry a *right to vote* at the general meeting, which is the company's highest governing body. Normally, the more shares the shareholder owns, the greater the shareholder's share of the capital, dividends and voting rights. However, voting rights may vary, depending on the class of shares. There are two types of limited company in Norway, *the public limited company (ASA)* and *the limited company (AS)*.

3.1.2 Share price

The **price** of a share is largely influenced by the **company's prospects**. Share prices can go up or down depending on market participants' analyses and assessments of the company's prospects of making **future profits**. Future external developments in the economic situation, technology, legislation, competitive conditions etc. determine the likely demand for the company's products or services and are therefore fundamentally important to the company's share price performance.

The **general level of interest rates** (market rate of interest) also plays a crucial role in share price performance. If the market rate of interest rises, interest-bearing financial instruments issued simultaneously can give better returns. Normally, this leads to a fall in the prices of listed shares, and interest-bearing instruments that have already been issued at lower rates of interest. The reason is that in relative terms the increasing returns on newly issued interest-bearing instruments may be better than the returns on shares and previously issued interest-bearing instruments. Moreover, share prices are influenced negatively because the rate payable on the company's debt rises, thus reducing the company's future profit outlook.

Other factors involving the company itself, for example changes in the company's management and organisation, or breaks in production etc., may also influence the company's future long-term and short-term profitability. In the worst case, things may go so badly that a company has to be declared **insolvent**. The share capital, i.e. the shareholders' invested capital, has the lowest priority for payment from the insolvent company's estate. The company's other debts must first be settled in their entirety. This often means that there are no funds left in the company, once debts have been repaid, and the company's shares become worthless.

The price performance of financial instruments listed on larger **foreign** regulated markets and other trading systems also affects share price performance in Norway, mainly because many Norwegian companies are also listed on foreign regulated markets or traded on other trading systems. Price equalisation (arbitrage) takes place between the markets. The share prices of companies in the same industry/sector are often influenced by share price changes in other companies in the same industry/sector. This effect may also apply between companies in different countries.

Financial market participants often have different opinions about how share prices will move. The above factors, and the way in which the company is valued, contribute to there being both buyers and sellers. If the investors have the same opinion about future price movements, they will either buy, leading to pressure to buy from many buyers, or they will sell, resulting in pressure to sell from many sellers. Pressure to buy forces prices up; pressure to sell forces them down.

Market **turnover**, i.e. the quantity of a particular share bought or sold, affects the share price. With high turnover the "**spread**", i.e. the difference between the price at which buyers are willing to buy (bid price) and the price demanded by sellers (offer price), is reduced. A share with high turnover, where large quantities can be traded without major effect on the price, has good **liquidity** and is therefore easy to buy and sell. Companies listed on a regulated market, for example Oslo Stock Exchange and Oslo Axess, normally have high liquidity.

The regulatory environment for business, both nationally and internationally, can also affect share prices. Changes in tax and duty rates nationally, and in other countries, affect companies' costs and thus their competitive situation. International agreements between countries on customs duties and charges, when goods and services are imported or exported, affect companies' relative competitive positions and therefore their share prices. Major events such as disasters, terrorist actions and war can seriously affect share prices on stock markets throughout the world.

Daily key price data showing for example, "highest, "lowest" and "latest" prices for the shares traded, as well as information about trading volumes, are for the most part published in the larger daily newspapers, in TV text services and on various websites run by marketplaces, securities firms and media undertakings. The extent to which this information is up to date may vary depending on the means of publication.

3.1.3 Trading in shares - including trading systems

Only shares issued by public limited companies (ASA) or similar foreign companies can be listed on a regulated market (including a stock exchange) in Norway. There are also requirements for the size of the company, its business history, diffusion of ownership and publication of the company's financial statements and other information about its business.

At present, there are two **regulated markets** in Norway for trading in shares; Oslo Stock Exchange and Oslo Axess. Only Oslo Stock Exchange has a **stock market** licence (www.oslobors.no). Oslo Axess (www.osloaxess.no) is to all intents and purposes subject to the same regulations that apply to Oslo Stock Exchange as regards following-up, monitoring and sanctioning any breaches of the regulations that apply to trading on a regulated market. Trading in Norwegian shares can also take place on regulated markets abroad, where several Norwegian companies are listed.

Trading in shares that are not listed on a regulated market takes place in what is known as the OTC market. Trading in this market is largely based on information about prices and interests that the stockbroking firms provide to one another. The most common method is that the stockbroking firm enters expressions of interest in buying or selling into a trading support system operated by Fondsmeglernes informasjonstjeneste AS. The OTC list is divided into an A list and a B list. Only companies registered on the A list are required to present significant price sensitive information to the market. For more information about the OTC list see www.nfmf.no. If a share is neither listed on a regulated market nor on a trading support system, sale or purchase will normally take place through the stockbroking companies endeavouring to support the client by contacting potential clients who may be interested in acting as counterparties. Investing in this type of share carries a significant liquidity risk.

Trading on a regulated market or other trading system comprises the **secondary market** for shares, primary capital certificates and bonds that a company has already issued. The OTC list also functions as a secondary market for shares. If the secondary market functions well, i.e. it is easy to find buyers and sellers, and bid prices from buyers and sellers are continuously listed along with closing prices for completed trades, the companies have an advantage as it will be easier to issue new shares and thus obtain more capital for the company's business. The **primary market** describes the market where trading/subscription of newly issued shares, primary capital certificates and bonds takes place.

Shares registered on a regulated market or other trading system are normally divided into various lists depending on the company's market value or its liquidity. These lists are generally published on the trading system's website, in newspapers and in other media. The companies listed on Oslo Stock Exchange are divided into four different segments depending on the company's liquidity. These are **OB Index**, **OB Match**, **OB Standard** and **OB New** respectively. In the course of the day or over longer periods, different shares show different degrees of price stability (*volatility*) i.e. the frequency and size of price changes. Shares listed as having high liquidity are normally considered to involve lower risk than shares listed with lower liquidity.

3.1.4 Different classes of shares

Shares can be in different *classes*, usually 'A' and 'B' shares, which is normally significant in the context of voting rights at the company's general meeting. Only a minority of Norwegian listed companies have different classes of shares. 'A' shares normally carry one vote, while 'B' shares usually have restricted voting rights or no voting rights. The differences in voting rights may, for example, exist in order to secure the original founders' and owners' influence over the company when ownership expands, by giving them more extensive voting rights.

3.1.5 Nominal value, split and reverse split

The *nominal value* of a share is the value that each share represents in the company's share capital. The total number of shares issued by a company, multiplied by the nominal value, equals the company's share capital. Now and again the company will want to change the nominal value, e.g. because the market price of the share has risen significantly. Dividing each share into two or more shares, known as a *split*, reduces both the nominal value of the shares and their price. The shareholder's capital, on the other hand, remains unchanged after the split, but it is divided into more shares with a lower nominal value and lower price.

The opposite is a *reverse split*, or consolidation. This is carried out, for example, if the share price falls significantly. Then two or more shares are merged into a single share. The shareholder, however, has the same capital after a reverse split, but it is now divided between fewer shares with a higher nominal value and a higher price.

3.1.6 Stock exchange introduction, privatisation and acquisition

A *stock exchange introduction* (or Initial Public Offering - IPO) means that a company's shares become listed on a regulated market (including a stock exchange). The public may then be invited to *subscribe* for (buy) shares in the company. This usually involves an existing, previously unlisted company whose owners have decided to increase the number of shareholders, as well as making it easier to trade in the company's shares. When a state-owned company is introduced to a stock exchange the process is known as *privatisation*, or part-privatisation, depending on the proportion of its ownership share the Government offers to sell to the public.

Acquisition normally takes place when one or more investors offer a company's shareholders the opportunity to sell their shares on certain conditions. If the purchaser obtains 90 % or more of the company's share capital and votes, the purchaser can petition for *compulsory acquisition* of the remaining shares from the owners who have not accepted the acquisition offer.

3.1.7 Issues

If a limited company wishes to expand its business, extra capital is often needed. The company obtains this by issuing new shares by means of an *issue*. The existing shareholders usually have *subscription rights* that allow them to subscribe on a pre-emptive basis when the issue is offered. The number of shares that can be subscribed is then determined in proportion to the number of shares the owner already holds. The subscriber must pay a price (issue price) for the newly issued shares, which may often be lower than the market price. Immediately after the subscription rights - which normally have a certain market value - are separated from the shares, the price of the shares normally falls. Those shareholders who have subscription rights but do not subscribe, may during the subscription period (which often lasts for several weeks) sell their subscription rights in the marketplace where the shares are listed. After the subscription period expires and the allotment takes place, the subscription rights expire and become worthless.

If the share premium reserve in a limited company has accumulated significant value, the company can transfer a proportion of the value to the shareholders in a *bonus issue*. In a bonus issue, the number of shares the shareholder already holds is taken into account. The number of new shares offered to the shareholders in a bonus issue is determined in proportion to the number of shares already owned. In a bonus issue, the shareholder receives more shares, but the proportion of the company's share capital owned remains unchanged. The share price falls when a bonus issue takes place, but because the number of shares has increased, the value of the shareholder's invested capital remains unchanged.

Limited companies can also make a *private placement* (directed share issue), which is executed as an issue, but is only aimed at a limited group of investors. In a private placement, the existing shareholders' proportion of the number of votes and share capital in the company is *diluted*, but they still hold the same number of shares and the market value of their invested capital is not usually affected.

3.2 General information about share-related instruments

Closely related to shares are: primary capital certificates, convertible bonds, share index bonds/index-linked bonds, warrants, share options and share index options, and depository receipts. Trading in these instruments normally takes place on a regulated market (including a stock exchange), but this type of financial instrument is also traded on the OTC.

3.2.1 Primary capital certificates

Primary capital certificates have clear similarities with shares. The differences are primarily to do with rights of ownership over company assets and influence in the issuer's governing bodies. Certain restrictions on dividend distributions are also imposed. The listed primary capital certificates in Norway are issued by the savings banks. More information about primary capital certificates can be found at www.grunnfondsbevis.no.

3.3.2 Convertible bonds

Convertible bonds are interest-bearing securities that can be converted into shares after a prescribed period. The return on the convertible bonds, i.e. the interest, is normally higher than the return from share dividends. The price of the convertible bonds normally follows the share price and is expressed as a percentage of the nominal value of the convertible bond.

3.2.3 Share index bonds/Index-linked bonds

Share index bonds/Index-linked bonds are bonds where the returns normally depend on the performance of a share index. If the index develops positively, the returns increase in step with the index. There may be no return if the index has a negative performance. The bond is always repaid at its nominal value on the expiry date and the risk of loss is therefore lower than with shares and fund units. The risk when investing in a share index bond, apart from any possible issue premium, is defined as the alternative interest income, i.e. the interest that the investment might have earned if the amount had been invested in another way.

3.2.4 Warrants

Trading also takes place in certain call and put options with a longer term to maturity than the standard call options. These are known as *warrants*. Warrants can be used to buy underlying shares, or give cash settlement if gains are made as a result of the price of the underlying share being higher than the contracted future bid price/redemption price.

3.2.5 Share options and share index options

There are various types of *share options*. Acquired (purchased) options to buy (call options) give the owner the right, within a set time period, to buy shares already in issue at a pre-determined price. Acquired (purchased) options to sell (put options) give the owner the right to sell shares within a set time period at a pre-determined price. For every *acquired* option there is a corresponding *issued* (sold) option. The risk for the investor who acquires an option is that it will fall in value or be worthless on the date of cessation. The issuer of an option runs a risk, which, if special precautions are not taken, may be limitlessly high.

Index-linked bonds give a gain or loss linked to the performance of the underlying index. The price of options (premium/price) normally follows the trend in the price of the corresponding underlying shares or index.

3.2.6 Depository receipts

Depository receipts are certificates for shares stored in a securities depository and give the owner the same rights as owning the share itself. Depository receipts are bought and sold like shares and price trends normally follow the performance of the regulated market abroad, where the share is traded.

4. INTEREST-BEARING FINANCIAL INSTRUMENTS (BONDS)

4.1 General information about interest-bearing financial instruments (bonds)

An interest-bearing financial instrument is a *receivable right* on the issuer of a loan. The return normally comes in the form of *interest (coupon)*. There are different forms of interest-bearing instruments depending on who the issuer is, the *security* provided by the issuer for the loan, the *term to maturity* and the way in which interest is paid.

The interest (coupon) is usually paid as either fixed or floating interest. For a fixed-interest loan the interest is normally fixed for one year at a time. For loans with a floating rate of interest,

the interest rate is normally fixed four times per year for three months at a time, based on the NIBOR rate. Some loans do not bear interest, but only the par value is paid out on the loan's date of maturity (zero-coupon loans). Zero-coupon securities are bought at a significant discount, which gives an effective rate of interest comparable to securities yielding coupon rates. For example, all debt issued by the Government as treasury bills (treasury certificates) is zero-coupon.

The *risk* in an interest-bearing instrument consists partly of interest rate changes that may occur during the term because of changes in the market rate of interest and partly of the risk that the issuer will be unable to repay the loan. Loans where adequate security for repayment is provided are thus less risky than unsecured loans. As a very broad general rule, the risk of loss on interest-bearing instruments is considered lower than for shares.

The market rate of interest is decided daily, both for short-term instruments with less than one year to maturity, e.g. *treasury bills*, and for longer-term instruments e.g. *bonds*. This takes place in the money and bond markets. The market rates of interest are influenced by analyses and assessments made by Norges Bank and other large institutional market participants, taking into account predicted long-term and short-term trends in factors such as inflation, the general economic situation and interest rates in Norway and other countries. Norges Bank also operates in the money and foreign exchange market with the aim of managing the development of the market rate of interest, so that inflation stays within set limits.

If market interest rates rise, the price of interest-bearing financial instruments already in issue will fall. This is because new loans are issued at rates based on the new current market rate of interest and they will therefore give higher returns than can be achieved by instruments already in issue. Conversely, the price of instruments already in issue will rise when the market rate of interest declines.

Loans issued by the Government, county councils and municipalities (or guaranteed by such organisations) are considered to be almost risk-free as regards repayment of the pre-determined amount on the date of maturity.

4.2 Trading in interest-bearing financial instruments (bonds)

Many bonds are stock exchange-listed, so these financial instruments are traded on a regulated market in the same way as listed shares. The Oslo Stock Exchange also offers an alternative marketplace for trading in bonds and treasury bills - the *Alternative Bond Market* (ABM). ABM is a separate marketplace. It is not regulated by the Stock Exchange Act or subject to licensing pursuant to that Act, but is administered and organised by the Oslo Stock Exchange.

Trading in bonds normally takes place in a different manner than for shares. In practice the interest and currency market can be regarded as a *quotation market* or *price-driven market*. This is in contrast to the stock market, which is an order-driven market.

When trading in standardised options, bonds, currency and interest derivatives, a firm normally indicates prices as market maker and publishes purchase and sale prices based on its own assessments of market conditions. The market will as a rule be very transparent, as prices are published on the firm's website or through an information distributor. Clients can thus compare prices between different firms. These prices will either be indicative or binding for a specific volume per transaction. If the prices are indicative, the firm will give the client a binding price on request. When contacting

the firm, the client is free to accept or reject the offer. If the client accepts the price, the firm will be the counterparty in the transaction.

5. DERIVATIVE INSTRUMENTS

Derivative instruments, such as options, forward exchange contracts etc. are issued for various types of underlying assets, for example shares, bonds, raw materials and currencies.

A special risk to be aware of when investing in derivative instruments is that the construction of the instrument means that the price development of the underlying asset is reflected in the price of the derivative instrument, known as the *gearing effect*. This price reflection is often more substantial in relation to the contribution than the value change in the underlying asset. The price reflection is therefore called the gearing effect and may lead to a *greater gain* on invested capital than if the investment had been made directly in the underlying asset. On the other hand, the gearing effect may mean a *greater loss* on the derivative instrument compared with the change in value of the underlying asset, if the price development on the underlying asset is different from that expected. The gearing effect, i.e. the possibility of gain or the risk of loss, varies depending on the derivative instrument's construction and area of application. It is therefore extremely important to monitor price developments in the derivative instrument and the underlying asset carefully. In their own interests, clients should be prepared to trade quickly, often during the same day, if the investment in the derivative instrument develops in an unfortunate direction.

For further information about derivative instruments, see “INFORMATION FOR CLIENTS ON THE CHARACTERISTICS OF OPTIONS, FORWARD EXCHANGE CONTRACTS AND OTHER DERIVATIVE INSTRUMENTS AND THE SPECIAL RISKS INVOLVED IN TRADING IN THEM”.

6. SECURITIES FUNDS

A securities fund is a “portfolio” of different financial instruments, for example, 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 different types of securities funds with different investment strategies and risk profiles.

A short description of the most common securities funds is set out below⁵:

Equity fund – a securities fund that will normally invest at least 80 per cent of the fund's capital in shares (or other equity capital instruments) and which does not normally invest in interest-bearing securities.

Combination fund – a securities fund that is not defined exclusively as an equity fund or interest fund. A combination fund may have a pre-determined proportionate split of shares and interest-bearing securities, but the proportion of different securities may also change during the life of the fund.

Fixed income fund – a securities fund that invests in securities other than shares. Fixed income funds are divided into bond funds and money market funds.

⁵ Source: www.vff.no

Index fund – a securities fund that is managed relatively passively in relation to the fund’s reference index.

Fund in fund – a securities fund that invests its assets in a single (or possibly several) underlying securities funds.

Hedge fund (specialist fund) – There is no exact definition of the term hedge fund and there may be considerable variation between individual hedge funds as regards investment choices and risk profile. Hedge funds usually take significantly higher risks than ordinary securities funds, and are therefore products for professional investors willing to take large risks. Hedge funds are not obliged to follow the Norwegian Securities Funds Act or the UCITS Directive. Such funds can usually take out loans and are usually quite free to use a variety of derivatives. A hedge fund can also trade securities “short”, which means that the fund sells borrowed securities and then purchases replacement securities of the same type, later on.

Unit holders receive the number of units in the fund that corresponds to their share of the invested capital in relation to the fund’s total capital.

Units may be bought and redeemed (sold) through the management company. The units’ current value is calculated daily by the management company and is based on the price development of the financial instruments in which the fund has invested. There are also units in funds that can be traded on a regulated market (**Exchange Traded Funds** – “ETF”).

At present two securities funds are traded on the Oslo Stock Exchange.

One of the ideas behind an equity fund is that positions are taken in a variety of shares and other financial instruments. This means that the risk for the unit holders is reduced, in comparison to the risks run by shareholders whose positions include only one, or a small number of shares. Unit holders avoid having to select, buy, sell and monitor the shares and carry out other related administrative work.

For more information about securities funds, see www.vff.no.

7. SHORT TRADING

“Short trading” means selling financial instruments that are not owned, by borrowing shares from a securities firm or in another way. Short trading is used as an investment strategy when it is expected that the price of the shares will fall. When borrowing, the short trader enters into a binding contract to return instruments of the same type to the lender at a later point in time. When the short trader sells the borrowed instruments, he is counting on being able to buy them back in the market, before they are due for return to the lender, at a lower price than that obtained when he originally sold them. There will be a loss if the price goes up instead of down, and if the price increase is large the loss may be significant.

8. LOAN-FINANCED TRADING

Financial instruments may in many cases be purchased with capital that is partly borrowed. Since both the contributed capital and the borrowed capital affect the return, the client can, through loan financing, obtain a greater gain if the investment develops positively, compared with an investment which is only made by investing the client’s own capital. The debt incurred when borrowing the capital is not affected if the price of the purchased instruments changes in a positive or

negative direction, but if the price development is positive an advantage is gained. However, if the price of the purchased instruments develops in a negative direction, this represents a corresponding disadvantage since the debt remains unchanged. In the event of a fall in price, the contributed capital may therefore be wholly or partly lost, while the debt must be repaid from the proceeds of selling financial instruments that have fallen in value. The debt must still be paid, even if the sales proceeds do not cover the entire debt.