RBSCIFL Derivatives Risk Management Policy Part 5

Funds Managed by Standard Life Investments Ltd

NatWest

Contents

1 Policy Statement

This policy document describes the use of derivative instruments within the Your Portfolio Funds of the RBS Investment Options Investment Company with Variable Capital ("ICVC"). In so doing it addresses:

- the objectives of the Fund,
- the strategies and instruments which can be used to achieve those objectives,
- the potential risks associated with those strategies and instruments, and
- the measures implemented to address and manage those risks.

The Funds' Prospectus sets out the broad investment policy under which the Funds may pursue derivative usage and should be read in conjunction with this document. Should there be any conflict between the Prospectus and the Derivatives Risk Management Policy, the provisions of the Prospectus will prevail.

This policy is subject to formal review annually, or more regularly as necessitated by changes to regulatory requirements or business strategy. Each update to this policy will be presented to and approved by the RBSCIFL Investment Management Committee ("InvCo").

This Policy will make reference to the Financial Conduct Authority's Collective Investment Schemes Sourcebook ("COLL"). This Sourcebook will be replaced by the Investment Funds Sourcebook ("FUND") for the Expert Managed Solutions Funds and the Your Portfolio Funds. At the time of publishing this policy the Financial Conduct Authority ("FCA") had not published all parts of this Sourcebook. You can find both Sourcebooks on the Financial Conduct Authority's website.

2 Derivatives defined

A "Derivative" is defined as a contract whose value depends on the value of an underlying asset, reference rate or index. For the purposes of this document, the applicable regulatory definition of derivative can be found within the Financial Conduct Authority Handbook Glossary as "a contract for difference, a future or an option".

3 Your Portfolio Funds defined

Standard Life Investments Limited manages the "Your Portfolio" range of funds within the RBS Investment Options ICVC. Currently, the funds available are:

Your Portfolio Fund II
Your Portfolio Fund III
Your Portfolio Fund IV
Your Portfolio Fund V
Your Portfolio Fund VI

The objective of the Funds is to provide a total return from a combination of income and capital appreciation over the medium to longer term. This is described in more detail in the prospectus, which is available from the Authorised Corporate Director ("ACD"), RBSCIFL, at its registered office.

The Fund will be invested mainly in a range of collective investment schemes to achieve a broad exposure to diversified investments in the UK and overseas. Investments may also be made in derivatives for hedging or Efficient Portfolio Management ("EPM") purposes. Further detail can be found in Section 4 below.

The risk appetite is set to the volatility expectations agreed with the Investment Manager ("IM"). This document is attached as an Appendix of the Overall Risk management Policy and Governance. The Investment Manager has a risk management process which covers all aspects of managing the fund portfolios including derivatives, using proprietary systems to manage the Fund portfolio as well as tools such as optimisation models.

4 Instruments Used

The IM does not use derivatives as part of its direct investment strategy. If this changed, then the form and frequency of monitoring of derivative investment risk would be agreed with InvCo and included in the reports issued to them. Notwithstanding this, the IM may only transact derivatives for either hedging or for efficient portfolio management ("EPM") purposes.

Hedging is defined in this context to mean transactions that lay off portfolio risks as to currency, interest rates or to reduce transaction costs.

EPM means transactions that facilitate rapid switching of portfolio investment or to reduce transaction costs.

Derivatives may be exchange traded or Over The Counter ("OTC") transactions (see section 8). Put and Call options may be bought or sold, provided they are covered and are not speculative.

However, the funds may invest a proportion of their assets in collective investment schemes that use derivatives in order to achieve their performance objectives. This can lead to increased risk due to the potential for large losses relative to the small financial outlay, and through counterparty risk.

5 Limits on Exposures

The total exposure to an asset class including that created by a derivative instrument is restricted to the limits imposed by the FCA's Collective Investment Schemes Sourcebook Part 5.

The exposure to any one counterparty to an OTC derivative transaction must not exceed 5% in value of the scheme property, unless the assets held are either government or public securities (COLL 5.2.11 (1)).

In the event of counterparty default the assets deposited as collateral will be transferred to the fund as required. These assets will then be invested, as far as possible, in line with the investment strategy in order to meet the fund's investment objective.

Initial oversight is provided by the Investment Manager ("IM"). Their reports are presented to InvCo for oversight with formal governance arrangements on a quarterly basis.

6 Risk

There are a variety of risks associated with any usage of derivatives by the Funds. The risk appetite is agreed with the Investment Manager, and is defined as the target volatility expectations, detailed in the Investment Management Agreement.

Reports on all aspects of risk and fund management are provided to InvCo on a quarterly basis, where they are discussed with the Investment Manager. Any issues are then dealt with as required, and may be referred to the RBSCIFL Oversight Committee if this is felt appropriate.

The risks relating to the usage of derivatives include:

Cash Flow Risk

The risk that the funds will have insufficient cash to meet the margin calls necessary to sustain its position in an exchange traded contract (e.g. where short-dated futures contracts are used to hedge long dated OTC transactions or where additional margin calls are made intra-day) and relevant OTC contracts.

Regulatory Risk

The Risk of disciplinary measures being taken against the fund due to breach of the rules/principles contained within the FCA handbook.

Reputational Risk

The risk of adverse publicity or perception of the ACD whether justified or not can impact upon the ACD. Such risks are considered within the governance of RBSCIFL and are managed through Operational Risk.

Market Risk

The fund will be exposed to changes in the market value of its investment positions. This can be caused by volatility of equities, exchange rates, interest rates risk and credit spreads. Hedging of a portfolio via derivative transactions can often reduce these risks but is not always appropriate. Market fluctuations and volatility may adversely affect the value of these positions or may reduce the willingness to enter into some new transactions.

Liquidity Risk

The absence of adequate liquidity which restricts investment opportunities is known as liquidity risk. When trading derivatives; market demand can impact the ability to acquire or liquidate assets, counterparty liquidity can be reduced by lower credit ratings or large cash outflows and margin calls can increase a fund's liquidity risk. Liquidity risk tends to compound other risks. If a Fund has a position in an illiquid asset, its limited ability to liquidate that position at short notice will compound its market risk.

Operational Risk

There is a dependency upon the ability to process transactions in different markets and currencies. Shortcomings or failures in internal processes, people or systems could lead to, among other consequences, financial loss and reputation damage. In addition, the ability to conduct business may be adversely impacted by a disruption in the infrastructure that supports the business and the communities in which they are located.

Credit Risk

Credit risk represents the loss that would be incurred if a counterparty fails to perform under its contractual obligations.

Exchange-traded derivatives are backed by the clearing organisation of the exchanges where they are traded.

The credit risk associated with OTC derivatives is managed by an appropriate Credit Support Annex ("CSA") under the International Swaps and Derivatives Association Master Agreement ("ISDA"), under which the derivatives provider is required to post collateral in respect of the derivatives it enters into with the ICVC, so as to reduce the ICVC's overall credit exposure.

Forward Foreign Exchange Risk

Forward contracts, unlike futures contracts, are not traded on exchanges and are not standardised. Banks and dealers act as principals in these markets, negotiating each transaction on an individual basis. Forward trading is substantially unregulated and there is no limitation on daily price movements and position limits are not applicable. The principals who deal in the forward markets are not required to continue to make markets in the currencies they trade and these markets can experience periods of illiquidity, sometimes of significant duration. Market illiquidity or disruption could result in losses.

Legal Risk

Legal Risk is the risk of loss due to the unexpected application of a law or regulation, or because contracts are not legally enforceable or documented correctly. The risks are largely minimised in respect of OTC derivatives by ensuring that ISDA agreements are in place with counterparties prior to trading.

The Investment Manager ("IM") does not currently use derivatives. Were derivatives to be used, the Fund operates on a more restrictive basis in any case. Derivatives transactions are not to exceed 10% of the value of the Fund. No gearing is permitted and the exposure is to be fully covered by cash. Cash may be in the form of a receivable. Positions are managed every day by the IM in conjunction with the management of cash and its movements to ensure that derivative transactions:

- Do not exceed 10% of the Funds' portfolios without permission from the ACD; and
- Positions are fully covered.

Positions are reconciled daily with the Clearing Agent and the necessary margin transfers are executed.

The IM is subject to independent oversight by their Compliance Department. Additionally, RBS UK Retail Compliance also carries out audit exercises on their processes and controls.

The perceived risks from investing in derivatives are:

- Normal Market Risk – the prices can go down as well as up in line with market movements.
- Credit Risk – risk that the clearing agent will default on open positions.

Valuation Risk

This is the risk that the valuation of specific transactions may not be accurate. The risk increases for OTC bespoke transactions where the counterparty is the primary pricing source and alternative market prices may not be available. The valuation risk associated with OTC derivatives is managed by independent price verification.

JP Morgan Worldwide Security Services ("JPMWSS") are responsible for calculating the Net Asset Value ("NAV") for each of the Funds. As part of this process, JPMWSS use their internal process to source the pricing to each of the assets of the Fund including the prices used in valuing any derivative instruments, both exchange traded and OTC. Any breaches of the investment limits set out in the prospectus or the FCA Rules would be brought to the attention of the Fund Governance Team. The IMs are responsible for measuring and managing the risks associated with the use of derivatives. The IMs are specialists in their respective fields and establish and monitor risk metrics appropriate to their respective investment styles. An Investment Management Agreement ("IMA") is negotiated and agreed which sets out that the Investment Manager is responsible for the day to day management of the assets and that it must abide by applicable laws and regulations including those set out by the FCA. Reference should be also made to the Derivatives Risk Management Policy ("DRMP").

The valuation rules of the Funds are contained in the section entitled "Valuations, Pricing & Dealing" as per the prospectus and in the Instrument of Incorporation under the section entitled "Valuations". The NAV of each Fund shall be calculated by the Company as at the Valuation Point for each Dealing Day by valuing the assets of each fund and deducting them from the liabilities of each fund. The Instrument of Incorporation and the Prospectus provides for the method of valuation of the assets and liabilities of each fund as follows. The price of a Share in the Company is calculated by reference to the Net Asset Value (or the relevant proportion of the NAV) of the Fund to which it relates. The Scheme Property attributed to each Fund will be valued at each Valuation Point on each dealing day. The value of the Scheme Property attributed to the Fund will be the value of its assets less the value of its liabilities. All the Scheme Property attributed to the Fund will be included in each valuation. In adverse market circumstances and unavailability of pricing please refer to the Unit Pricing policy and the Fair Value policy.

There are also a variety of risks specific to the instruments that could be used as detailed below:

Purchased Options

Purchased Option contracts are exposed to a maximum loss equal to the price paid for the option (the premium) and no further financial liability.

Written Options

Written options give the right of potential exercise to a third party. This creates exposure for the fund as they may have to deliver out the underlying asset, and should the market move unfavourably, result in a loss. The maximum loss for the writer of a put option is equal to the strike price less the premium received. The maximum loss for the writer of an uncovered call option is unlimited.

In the case of a written option on a future, the notional underlying asset is not delivered upon exercise, as the contract is cash settled. The fund's financial liability is therefore linked to the marked-to-market value of the notional underlying asset.

OTC options although providing greater flexibility may involve greater credit risk than exchange-traded options as they are not backed by the clearing organisation of the exchanges where they are traded. The risk of holding OTC instruments is linked to the counterparty with whom the trade is placed as well as the underlying asset.

In the case of each of the Funds the use of derivative transactions is limited to Efficient Portfolio Management ("EPM") techniques as described below. RBSCIFL has no appetite for derivative transactions to be entered into on behalf of the Funds for speculative or gearing purposes and current Your Portfolio Funds do not invest in derivatives.

Efficient Portfolio Management must satisfy three broadly based requirements:

1) A transaction must be one which (along or in combination with one or more others) is reasonably believed to be economically appropriate to the efficient portfolio management of the Fund.

   EPM may not include transactions which may reasonably be regarded as speculative.

2) The purpose of a derivative transaction for a Fund must be to achieve one of the following aims:

   (a) ***Reduction of risk***. One example of how a derivative transaction would achieve this aim is in the use of cross-currency hedging where all or part of the currency exposure of a Fund may be switched away from a currency considered to be unduly prone to risk, to another currency. Another example is the use of derivative transactions in tactical asset allocation, which allows a switch in exposure to different types of asset by way of derivative transactions rather than through the sale and purchase of underlying assets.

   (b) ***Reduction of cost***. The aims of reduction of risk or cost, together or separately, allow a Fund on a temporary basis to use the technique of tactical asset allocation, as described above.

   (c) ***The generation of additional capital or income for the Fund with no, or an acceptably low level of, risk***. There is an acceptably low level of risk in any case where it is reasonably believed that the Fund is certain (or certain barring events which are not reasonably foreseeable) to derive a benefit. For example, the generation of additional capital or income may arise out of taking advantage of price imperfections.

3) No transaction may be entered into unless the maximum potential exposure created by the transaction is covered individually under A and B or Globally under C:

   (a) Exposure is covered individually if there is a transferable security or other property which is of the same kind and sufficient in amount to match the exposure and (in the case of exposure in terms of money) cash or near cash or transferable securities which may be turned into cash in the right currency will be sufficient to match the amount of exposure.

   (b) Exposure to an index or basket of securities or other assets is covered individually, if the fund holds securities which can reasonably be regarded as appropriate to provide cover for the exposure; they may be regarded so even if there is not complete congruence between the cover and the exposure.

(c) Exposure is covered globally after taking account of all the cover required in A or B for other positions already in existence, and there is adequate cover available to enable the fresh transactions to be entered into.

RBSCIFL will place reliance on the expertise of the IM in making an assessment as to whether derivative transactions entered into on behalf of the Funds meet with the above criteria and are consistent with the restrictions laid down in the Prospectus and this Policy.

7 Limits on Exposures

The total exposure to an asset class, including that created by a derivative instrument, is restricted to the limits imposed by the FCA Collective Investment Schemes Sourcebook ("COLL") Part 5.

The limits on any exposure must also take account of the Regulatory requirement to maintain a "Prudent Spread of Risk" (FCA COLL 5.2.3).

Their reports are presented to InvCo quarterly for discussion and scrutiny.

Global exposure may not exceed 210% of the Fund's NAV on a permanent basis. The 210% global exposure is comprised of a maximum of 100% exposure to long positions, 100% derivatives exposure (covered globally by the 100% in long positions) and up to 10% borrowing.

Derivatives exposure may not exceed 100% of the Fund's NAV on a permanent basis.

Borrowing may not exceed 10% of the Fund's NAV under any circumstance and should only be temporary.

Whilst initial oversight is provided by the IM, Standard Life Investments do provide a quarterly compliance certification and Management Information on a monthly basis detailing the exposure limits in addition to a breakdown of the composition of the fund to InvCo to review on a quarterly basis.

8 Exposure Measurement

If the Investment Manager began to use derivatives, then it would use the "commitment approach" to risk monitoring. Under the "commitment approach" positions in derivatives and forwards positions are converted to the equivalent position in the underlying assets.

In the case of options the equivalent cash position can be calculated by reference to the delta of the option.

Should the IM undertake more complex derivatives strategies the above procedures may not be sufficient to accurately measure exposure and it would be expected to move to a process based on an estimate of the maximum possible loss represented by the transaction.

The Investment Manager monitors the derivatives positions on a daily basis, with regular reporting provided to RBSCIFL. Positions are downloaded from the accounting system into a series of spreadsheets which flag breaches of the limits approved by RBSCIFL. A breach of any parameter or limit triggers escalation to RBSCIFL. The escalation process will result in corrective action by the Investment Manager. The exact action taken will depend on the type of breach. All breaches will be reported to RBSCIFL.

9 Reporting

A quarterly report is produced for discussion and challenge at InvCo. This details the activity in the funds, including performance, compliance and market commentary. The report shows:

- Performance and volatility against objectives by investment type
- Performance against peer groups
- Performance against indices
- Derivatives exposure (if any)
- Summary of activity
- Reporting of any compliance issues such as breaches, risk reporting and governance issues
- Market commentary.

It should be noted that any derivatives exposure is included in this report, and is used to manage the Investment Manager against their performance objectives and the parameters within which they are required to operate. This is carried out at InvCo, where the Investment Manager is in attendance. Certain issues may be flagged up to the Oversight Committee at the discretion of the Chairman of InvCo. Additionally, the Chairman of InvCo produces a summary of the main points from all the InvCo meetings for the Oversight Committee, which includes all items which ought to be brought to their attention for discussion or agreement.

Additionally, a weekly report is sent to the Chair of InvCo by the IM, detailing the global exposure to derivatives.

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