# RBSCIFL Derivatives Risk Management Policy Part 2

## Funds Managed by Aviva Investors Global Services Limited ("AIGSL")

Royal Bank of Scotland

# Contents

## 1) Policy statement

This policy document is intended to cover the use of derivative instruments in the Investment Company with Variable Capital ("ICVC")s and funds listed in Section 2 below. The document also addresses the types of instruments and strategies that may be used, and the inherent risks associated with such strategies, setting the control framework under which derivative instruments are monitored and controlled. For the purposes of this document, any reference to the word 'fund(s)' or 'sub-fund(s)' shall mean any of the ICVCs or any of the sub-fund(s) listed in Section 2 below.

The Prospectuses set out the broad investment policy under which any sub-fund may pursue derivative usage and should be read in conjunction with this document. Should there be any conflict between the Prospectuses and the Derivatives Risk Management Policy, the provisions of the Prospectuses 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 RBS Collective Investment Funds Limited ("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) ICVCs and Funds Covered

Aviva Investors Global Services Limited ("AIGSL"), as the fund management arm of Aviva Plc, are fund managers for the following ICVCs:

| | |
|---|---|
| RBS Investments Funds ICVC: | Growth Fund<br>International Growth Fund<br>Equity Income Fund<br>Extra Income Fund<br>High Yield Fund<br>Balanced Fund |
| RBS Stakeholder Investment Fund ICVC: | Stakeholder Fund |
| RBS Investment Options ICVC: | Income Fund<br>Cautious Growth Fund<br>Balanced Growth Fund<br>Adventurous Growth Fund |

## 3) 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's Handbook Glossary as "a contract for differences, a future or an option".

## 4) Applicable regulations

Specific restrictions on the use of derivatives within Collective Investment Schemes are set out in the Financial Conduct Authority's Collective Investment Schemes Sourcebook Part 5. ("Derivative Exposure" COLL 5.3) Funds are managed consistently with the guidelines set out in Committee of European Securities Regulators ("CESR")s Guidelines on Risk Management and the Calculation of Global Exposure and Counterparty Risk for UCITs.

## 5) Permissible strategies and instruments

### Overall nature

The RBS Stakeholder Investment Fund ICVC, each sub-fund of the RBS Investment Funds ICVC and the Expert Managed Solutions ("EMS") funds of the RBS Investment Options ICVC, have a specific stated investment objective and policy; these can be found in the latest published Prospectuses available from the Authorised Corporate Director ("ACD") at its registered address.

Derivative instruments may only be used for any sub-fund, if their use is consistent with that sub-fund's objective.

This policy document and the Prospectuses, prohibit the use of derivatives for speculative purposes. Derivatives may be used for the purpose of reducing risk, reducing cost or generating additional capital or income with no, or an acceptably low level of, risk and any other hedging purpose, as defined by the characteristics of Efficient Portfolio Management (see section 6, under "Valuation Risk").

A hedge is defined as a transaction designed to produce a profit that correlates reasonably with a potential loss, on an exposure that arises within a scheme as a result of a movement in the financial variable against which the hedge is intended to protect.

Gearing created by derivative instruments is not permitted on any sub-fund.

**Derivative instruments which can be used within the sub-funds are;**

| Equities | Bonds & Fixed Income | Currency |
|---|---|---|
| Options | Options | Options |
| Futures | Futures | Futures |
| Index futures | Interest Rate Options | Forwards |
| Options on Equity Indices | Interest Rate Futures | Swaps |
| Swaps | Interest Rate Swaps | |
| Warrants | Interest Rate Swaptions | |
| Convertibles | Options on Bond Futures | |
| | Forward Rate Agreements | |
| | Convertibles | |

The Authorised Corporate Director, RBSCIFL, will notify the FCA before it makes a material alteration to the above approach.

The Investment Manager is required to submit all requests for the addition of new instruments to the RBSCIFL InvCo, in order for new instruments to be formally approved.

## 6) Risk

There are a variety of risks associated with the Funds' usage of derivatives. The risk appetite is agreed with the Investment Manager, and is defined as the investment tracking error, as detailed in the IMA (see the appendices of the Overall Risk Management Policy and Governance). Investment concentration limits are set out in the Investment Concentration Limits document (see the appendices of the Overall Risk Management Policy and Governance).

Reports on risk and fund management are provided to InvCo on a monthly 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 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 Over The Counter ("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 Funds will be exposed to changes in the market value of their 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 the Funds' investment positions.

### 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. See the ISDA and CSA for more detailed information.

## 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.

## 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 Securities Services ("JPMWSS") for the Investment Options ICVC, and Bank of New York Mellon ("BNYM") for Investment Funds and Stakeholder Fund ICVC are responsible for calculating the Net Asset Value ("NAV") for each of the sub-funds of the ICVCs. As part of this process, JPMWSS/BNYM use their internal process to source and check the prices for each of the assets of the sub-fund of the Fund including the prices used in valuing any derivative instruments, both exchange traded and over the counter ("OTC"). Any breaches of the investment limits set out in the prospectus or the FCA Rules would be brought to the attention of RBSCIFL. The Investment Managers are responsible for measuring and managing the risks associated with the use of derivatives. The Investment Managers 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 sub-funds of the Fund are contained in the section entitled "Valuations, Pricing & Dealing" as per the relevant Prospectus and in the Instrument of Incorporation under the section entitled "Valuations". The NAV of each sub-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 from them 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 NAV (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 circumstance and availability 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 will 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.

Over the counter 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.

**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.**

EPM 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 Investment Manager (AIGSL) in making an assessment as to whether derivative transactions entered into on behalf of the Funds meet with the above criteria. In addition all derivative positions are taken into account within the Portfolio Risk Review (see section 10.4), ensuring that derivative transactions 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 and 5.6.3).

Initial oversight is provided by the Investment Manager (“IM”). Their reports are presented to InvCo quarterly for discussion and scrutiny.

### Over the counter derivatives

OTC derivatives are not traded on a recognised exchange, consequently the risk of holding such instruments is linked to the counterparty with whom the trade is placed as well as the underlying asset. Measures for controlling and monitoring counterparty risks are covered below.

The exposure to any one counterparty of an OTC derivative transaction must not exceed 5% in value of the scheme property. This limit is raised to 10% where the counterparty is an approved bank.

### Exchange traded derivatives

Exchange Traded (“ET”) derivatives trade on recognised exchanges and are not subject to the same level of counterparty risk as OTC derivative instruments.

## 8) Cover for derivative positions

Any derivative position within a sub-fund must be fully covered. The types of cover required and examples of their calculation are set out below.

One of the key controls required by the FCA regulations for Collective Investment Schemes is for any derivatives trades to be “covered” by physical assets, so as to avoid gearing the funds or opening the schemes up to an exaggerated level of risk by creating an uncovered exposure.

### BASIC PRINCIPLES

The main points regarding cover are shown below.

**Please note that all examples below are shown for illustrative purposes only, and are not necessarily indicative of the objectives and policies of the ICVCs and sub-funds concerned.**

- *The purpose of the cover rules is to prevent gearing.* A fund with £100m to be invested can either be invested in £100m of equities, or perhaps a futures contract with £100m of notional exposure. As the futures contract requires only approximately £5m in cash outlay (i.e. margin) for that £100m exposure, £95m must be set aside in cash to prevent the fund manager from entering into more futures trades that will expose the fund beyond £100m.
- *Long exposures are covered by cash. Short exposures are covered by long assets.* A long investment can only ever fall by its original cost (e.g. a stock costing £100 can only ever fall to zero and lose the investor £100), while a short investment has unlimited loss potential (a stock sold short at £100 exposes the investor by an unlimited amount if the price rises to £500, £1,000 or more). Because of this distinction, cash can cover long exposures, but physical assets must be used to cover shorts – if a fund holds £100m in short futures exposures, then the cover must be £100m in equities (as that is the only efficient hedge for a rise in price).
- *Physical Assets covering Shorts must be “Congruent”.* The long asset being used to cover a short derivative will act to offset the short’s price rise, but only if it is of a similar nature. For example, UK equities do not provide cover for a short US futures trade because if US prices rise and UK prices fall, there are losses on each side of the trade, exposing the fund to geared exposure. Therefore, for short derivatives, assets must be examined for similarity or where appropriate “congruence” (i.e. low tracking error).

## COVER SPECIFICS BY ASSET TYPE

Derivatives trading across the sub-funds comprise ET and OTC Equity, Fixed Interest ("FI") and currency futures, options, swaps and swaptions. These are addressed in turn below. Note that there is no distinction between ET and OTC for cover purposes – both types of derivatives can cause gearing in the funds, so the FCA requires cover in either case.

## 9) Type of risk and appropriate strategies

| Type of risk | Measure of underlying exposure | Exchange Traded | Over the counter |
|---|---|---|---|
| Equity Price Risk | Market Value of equity assets | Equity futures traded on an eligible derivatives market as approved by the Manager | |
| Overseas Interest Rate Risk | Market Value of overseas fixed interest assets | Bond futures and interest rate futures traded on an eligible derivatives market as approved by the Manager. | Interest Rate Swaps<br>Interest Rate Swaptions |
| Currency Risk<br>(i) Linked to the purchase or sale of an investment | Market Value of overseas assets | Not Applicable | Not Applicable |
| Currency Risk<br>(ii) To provide asset cover for asset allocation switches | Market value of switched assets | Not Applicable | FX Currency Forwards – hedging to/from sterling (including via a third currency)<br>FX Currency Forwards – hedging to/from non-sterling currencies |
| Currency Risk<br>All other transactions not included in (i) and (ii) above, such as corporate actions | Market Value of relevant assets | Not Applicable | FX Currency Forwards – hedging to sterling (including via a third currency)<br>FX Currency Forwards – hedging to/from non-sterling currencies<br>Purchased Call & Put Currency Options hedged to or from sterling |
| Equity Price Risk | Market Value of Warrant/ Convertible | Warrants;<br>Convertible Stocks | |

## 10) Risk Management

Specifically in relation to the sub-fund(s) noted under Section 1 (Policy Statement), under the investment management mandate particular to those sub-fund(s), the RBSCIFL Board delegates day to day derivatives risk management activities to the Investment Manager (AIGSL), but oversight is maintained by the ACD.

### 10.1) Governance

The Investment Manager's governance structure in relation to derivatives risk management is as follows:

#### 10.1.1) AIGSL Derivatives Officer

The Aviva Investors UK Derivatives Officer oversees governance of derivatives usage by Aviva Investors UK.

The Derivatives Officer's responsibilities include:

- Ensuring that all material derivatives related risks are identified. These include those that arise from, inter alia,
  - OTC derivatives;
  - Exchange traded derivatives;
  - Structured products;
  - Regulatory changes including but not limited to local implementation of the G20 initiative on OTC clearing, reporting and transparency
  - FX derivatives (including non-deliverable forwards – NDFs)
- Developing and maintaining a consistent derivatives risk management framework and monitor the management of derivatives exposures and risks in accordance with the approved strategies and the derivatives related requirements contained in the Aviva Investors Fund Management Standard.
- Monitoring adherence to the standard within the relevant Aviva Investors region.
- To maintain derivatives risks in accordance with the standard and to promote and approve any required changes to these, which are in accordance with the standard.
- To review and approve reporting, escalations, or any proposals for new instruments required to be presented to the Operational Risk and Reputational Committee (ORRC) as appropriate.

- Agreeing standard ISDA terms with the legal team for inclusion in new and existing ISDA agreements.
- To review derivatives activity and exposures against risk appetite and highlight where the activity exceeds the risk appetite of Aviva Investors.
- To assess whether appropriate mitigating actions are being undertaken in the event of a derivatives related control deficiency in any of the local jurisdictions.
- Provide thought leadership to the Aviva Investors Executive in respect of external industry developments and proposing action plans as appropriate.

**10.1.2) AIGSL Portfolio Risk** is independent of the Portfolio Managers and dealers and has a direct reporting line to the Investment Manager's Chief Financial Officer ("CFO"). Portfolio Risk is responsible for ensuring that derivatives usage is appropriate to the objective of the fund.

**10.1.3) AIGSL Credit Officer**

The Aviva Investors Credit Officer oversees governance of Counterparty Credit issues within Aviva Investors.

The Credit Officers responsibilities include:

- Ensuring that all material counterparty credit risks are identified. These include those that arise from, inter alia,
  - Money market counterparties
  - Derivatives counterparties
  - Securities brokers
  - Clearers
  - FX Counterparties
  - Securities Finance counterparties
  - Custodians
- Establishing effective local guidelines and procedures for the management of counterparty credit risk which are consistent with the AICCC Policy and, where appropriate, the Aviva Group Credit Standard.
- Approving new brokers and counterparties and where necessary setting appropriate limits.
- Periodically reviewing brokers and counterparties for continued creditworthiness.
- Removing brokers and counterparties from authorised lists where they cease to meet the required standards of creditworthiness.
- Monitoring exposure levels to brokers and counterparties.
- Agreeing with the legal department the standard terms to be used in ISDA/CSA agreements for the purposes of mitigating credit risks and agreeing any exceptions to the standard.
- Working with the Financial Event Response Team in the event of a credit crisis.
- Providing (high level) reports to the ORRC.
- Reporting material, unresolved conflicting opinions to the ORRC.
- Facilitating the sharing of credit analysis between regions where required.

**10.1.4) AIGSL Compliance and Business Risk** monitors operational and regulatory risk and reports directly to the Investment Manager's CRO. The team are responsible for the immediate notification of any breaches to RBSCIFL. All breaches must be resolved as soon as reasonably practical, with a finalised breach form to be provided to RBSCIFL within 10 business days. RBSCIFL will be responsible for the immediate notification of all breaches to the Depositary.

**10.1.5) AIGSL Middle Office** performs the derivatives post trade compliance function, including spread and concentration testing and reports directly to the Investment Manager's Chief Operating Officer (COO).

**10.1.6) Aviva Group Risk** undertakes independent reviews of the Investment Manager's internal controls and procedures on a periodic basis and works closely with AIGSL Compliance and Business Risk.

## 10.2) Exposure Limits

Exposure limits, which are prescribed by the FCA Collective Investment Schemes Sourcebook ("COLL") Part 5.3, are monitored on a daily basis by the Middle Office Team for the key areas outlined below:

**10.2.1) Global exposure** may not exceed 210% of the sub-fund's Net Asset Value ("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.

**10.2.2) Derivatives exposure** may not exceed 100% of the sub-fund's NAV on a permanent basis.

**10.2.3) Borrowing** may not exceed 10% of the sub-fund's NAV under any circumstance.

**10.2.4) Concentration** of net exposure to any group, including aggregate exposure to individual counterparties within that group, may not exceed 20% of the NAV of the sub-fund. The exposure to any one counterparty in an OTC derivative transaction must not exceed 10% of the scheme property where the counterparty is an Approved Bank and 5% of the scheme property where the counterparty is an eligible institution. For the purpose of calculating the limits, the exposure may be reduced to the extent that collateral is held in respect of it. See Investment Concentration Limits document (an appendix of the Overall Risk Management Policy and Governance).

To take account of the diversification requirements of the CESR Guidelines, the CSA requires the collateral of each fund to be spread as follows:

- No more than 40% in Italian Bonds
- 15% to 25% in French Bonds
- 35% to 45% in German Bonds

The Portfolio Manager of the sub-fund is responsible for immediately rectifying any breach of exposure limits. Derivative positions will be required to be sold out in order to bring exposure limits back within acceptable levels. Where exposure limit breaches are advertent these will be corrected at no cost to the Fund. A full assessment will be undertaken and a breach form reported, in order to identify areas of weakness and implement remedial actions to prevent recurrence.

## 10.3) Exposure Measurement

The Investment Manager is currently undertaking 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 Investment Manager 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 Team 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.

## 10.4) Portfolio Risk Review

The AIGSL Investment Risk team monitors all sub-funds on a daily basis to monitor trends and exceptions and undertakes a formal review for all sub-funds monthly, as part of the risk management process for each investment desk. The risk analysis includes a full decomposition of tracking errors and all derivative positions are taken into account in the review.

The purpose of the review is to ensure that all sub-funds are managed consistently with the prospectus, to maximise the probability of achieving their objectives and to avoid excessive volatility that may lead to unacceptable losses.

The results of the review are reported to a monthly meeting with each investment desk. Any unresolved issues arising from the review are escalated to the relevant Investment Manager's CIO and to the Aviva Investors Investment Committee.

To ensure continuing validity of the models used in risk analysis, forecasts are reviewed against actual outcomes and any material differences are subject to further investigation.

## 10.5) Risk Monitoring and Control

### 10.5.1) Valuation

A transaction in derivatives is subject to verifiable valuation only if, throughout the life of the derivative (if the transaction is entered into) verification of the valuation is carried out by an appropriate third party which is independent from the counterparty of the derivative, at an adequate frequency and in such a way that the authorised fund manager is able to check it. For RBSCIFL Exchange Traded derivatives are valued using prices fed directly from a pricing source that is linked through a relevant market or exchange. RBSCIFL funds are considered to be vanilla in nature and any use of derivatives is limited to EPM use only.

### 10.5.2) Exposure Limits

The AIGSL Middle Office Team performs daily checks to ensure that derivatives exposures comply with the exposure limits stated in Section 10.2 above and any additional portfolio-specific limits. Any breach will be reported to the Portfolio Manager and the Portfolio Risk Manager for investigation and immediate remedial action.

### 10.5.3) Cover

The individual types of cover and methodology for calculation of appropriate cover are discussed in 7 above. The AIGSL Middle office team checks the daily cover check breach report generated from the post trade compliance system to ensure that each derivative position is covered by the appropriate securities or cash. In line with the general policy stated within the Prospectus, no uncovered positions are permitted. Any breach of cover requirements is notified to the Portfolio Manager for immediate remedial action and any position that is not fully covered will be reduced or closed out entirely.

### 10.5.4) Margins

Margins for exchange-traded positions are calculated daily by the relevant investment exchange on which they were traded.

OTC derivatives do not have standardised margin requirements and initial and variation margin requirements are manually calculated.

### 10.5.5) Collateral

Collateral and settlement amounts for OTC positions are calculated daily by the counterparty and agreed with JP Morgan on behalf of AIGSL. COLL 5.6.7 (8) sets out the various conditions which the collateral deposited must satisfy in order to reduce exposure to the counterparty. The conditions referred to above are that the collateral:

(a) is marked-to-market on a daily basis and exceeds the value of the amount at risk;

(b) is exposed only to negligible risks (e.g. government bonds of first credit rating or cash) and is liquid;

(c) is held by a third party custodian not related to the provider or is legally secured from the consequences of a failure of a related party, and

(d) can be fully enforced by the UCITS or non-UCITS Retail Scheme at any time.

### 10.5.6) Eligible Counterparties and Exposures

OTC positions are both priced and traded with counterparties rather than via an exchange. Monitoring of Counterparty exposure, including recognised exchanges is the responsibility of Investment Manager's Credit Officer.

### 10.5.7) Dealing Authority

A monthly review is conducted by the AIGSL Middle Office team to ensure that staff initiating, authorising and executing derivatives transactions are authorised to do so.

### 10.5.8) Compliance – Procedures

The Investment Manager's Compliance and Business Risk department perform regular and independent monitoring to ensure that all derivative-related procedures are being adhered to, that appropriate checks have been performed and sign-offs have been obtained.

### 10.5.9) Compliance – Prospectus and Regulations

The AIGSL Middle Office team perform regular reviews to ensure that the investment restrictions detailed in the Scheme Prospectus, the FCA rules, UCITS and AIFMD legislation are being adhered to.

### 10.6) Risk Reporting Requirements

The following risk reports are produced and reviewed on a daily or monthly basis, as appropriate:

#### 10.6.1) Volume of Derivatives transactions reports

A daily report is produced by the AIGSL Middle Office Team which shows the number and economic value of derivatives transactions by portfolio type and instrument type. The report is provided to the Portfolio Manager and the Portfolio Risk Manager and presented to the AIGSL and Aviva Derivatives Committee monthly.

#### 10.6.2) Portfolio Risk Reports

A Portfolio Risk report is prepared by the AIGSL Portfolio Risk Team for use in the risk review process with the Portfolio Managers.

## 11) Reporting

As detailed in section 5.1 of the Overall Risk Management Policy and Governance, a Monthly Compliance and Risk Report is produced for discussion and challenge at InvCo. This report details any breaches or errors that have occurred during the month. It also the tracking errors for each fund compared with its target and range, as well as the fund turnover for the month in question and the last 12 months. The report covers the following topics:

- Legal restrictions
- IMA & Prospectus restrictions
- Tracking errors
- Fund concentrations
- Derivatives exposure
- Absolute risk
- Fund turnover
- Fund liquidity (to cover encashments)

It should be noted that 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 Board Investment 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 Board Investment Committee, which includes all items which ought to be brought to their attention for discussion or agreement.

## 12) European Market Infrastructure Regulation (EMIR)

### 12.1) Background

EMIR stands for European Market Infrastructure Regulation and applies directly to each member state of the European Union. Its main change is to bring most OTC (Over The Counter) derivative contracts into clearing (mechanism for the management of sales and purchases) through centralised clearing houses rather than remaining as stand-alone bipartite agreements. This effectively brings the transactions onto a recognised exchange.

EMIR also included the following changes:

- Regulators have acknowledged that there will be certain OTC derivative contracts that may never be cleared through a clearing house and so they introduced additional risk mitigation requirements for these;
- A reporting obligation for all derivative contracts, whether exchange traded or OTC; and
- A common regulatory regime for central clearing houses and trade repositories across Europe.

The aim is to ensure better oversight of the market, better information for regulators and enhanced reduction in risk.

EMIR applies to each counterparty to a derivative trade, meaning that many of the obligations of EMIR apply to RBSCIFL's ICVCs.

RBSCIFL also holds exchange traded derivatives ("ETD") in a number of its funds. These ETD, together with any OTC derivatives, need to be reported under EMIR.

### 12.2) Reporting Requirements

EMIR puts in place a 'Trade Repository' which is a data collection agent. Information returns on all derivative contracts is required to be made to these Trade Repositories, and each will handle the data requirements for specific product types. There are 6 Trade Repositories that have been approved by the relevant EU body and only 3 are being referred by IMA members. These are DTCC, Unavista & Regis-TR with most UK market participants using DTCC.

The data required to be reported together with information on how to obtain a LEI (Legal Entity Identifier) has only recently been finalised. We have obtained LEIs for all Funds that use derivatives and the key reporting dates are shown below.

Aviva Investors delegates this reporting to the relevant counterparty for the Funds they manage on behalf of RBSCIFL.

Aviva Investors has delegated reporting arrangements to trading counterparties which are reporting to the DTCC Trade Repository.

### 12.3) Rules Under EMIR on Dispute Resolution and Portfolio Reconciliation

EMIR requires counterparties to OTC derivative contracts that are not cleared by a central counterparty to mitigate their trading risks by using a number of different techniques. The following rules came into effect on 15 September 2013:

- The requirement for counterparties to agree arrangements for the reconciliation of their OTC derivative contracts.
- The requirement for counterparties to agree procedures in relation to the identification and resolution of disputes.

The rules have "direct effect", meaning that local regulators are not required to implement the rules into their own rulebooks.

### Summary of the rules

The rule on portfolio reconciliation requires counterparties to agree in writing a process for reconciling portfolios. The reconciliation must cover "key trade terms" and the trade valuation. The agreed process must be in place before entering into a derivative trade. The frequency of the reconciliation depends on the number of contracts outstanding between two counterparties. In the case of a financial counterparty, such as the RBS Investment Funds ICVC, this is once per quarter.

The rule on portfolio compression requires counterparties with 500 or more OTC contracts to have in place procedures regularly (at least twice a year) to conduct a portfolio compression exercise so does not apply to the RBS Investment Funds ICVC.

The rule on dispute resolution requires counterparties to have agreed detailed procedures and processes in relation to the identification, recording and monitoring of disputes relating to the valuation of the contract and the exchange of collateral, and to agree a process to resolve disputes in a timely manner with a specific process for those disputes which are not resolved within 5 Business Days.

Financial counterparties must report to their regulatory authority any disputes in relation to an amount or value higher than EUR 15 million and which are outstanding for at least 15 business days. The FCA has provided guidance on this reporting obligation. In order to report, financial counterparties must register with the FCA EMIR web portal. By the 15th day of each month, financial counterparties must ensure that any disputes outstanding in the previous month have been submitted to the EMIR web portal, including details of the amount (in euros) of the dispute.

Financial counterparties, such as RBS Investment Funds ICVC, should have procedures in place to identify disputes which need to be reported, and should register on the web portal in advance of actually reporting any disputes.

### 12.4) Rules Under EMIR on Timely Trade Confirmations

The need to improve the quality and timeliness of the trade confirmations process has been recognised by the industry for quite some time and significant progress has been made. Under EMIR trade confirmations have to be executed by the counterparties to the trade (electronically or in writing) within a set time frame, depending on asset class and counterparty classification. For equity derivatives, the timescales were T+3 up to 31 August 2013, T + 2 up to 31 August 2014 and T + 1 thereafter, where T is Trade date, and + indicates the number of business days after the trade date.

This requirement will arguably accelerate the current push towards using electronic affirmation systems which provide the opportunity for near-time confirmations. An additional EMIR requirement states that all counterparties need to report to their regulator all OTC derivatives trades which are still unconfirmed more than 5 business days after trade date.

These deadlines would apply to new derivative trades but also apply to unwinds to cover repurchases by investors with the partial encashment representing a derivative trade. The current process involves the unwind documents for each Fund being prepared by the Counterparty and e-mailed by the Investment Manager to RBSCIFL. The amounts involved are based on encashments advised by IFDS on the Weekly Valuation Date based on the latest agreed valuation.

The process is owned for RBSCIFL by Financial Control with others providing holiday cover.

### 12.5) Reporting to FCA Under EMIR

A log of disputes and timely confirmations (within 5 business days) will be maintained by Financial Control and will feature within their reporting returns to FCA by the 15th business day of the month on any such infringements of these conditions (i.e. on an exception basis only).

This will be required in addition to the regular reporting under section 12.2.

### 12.6) EMIR Controls

The following controls are in place to support client compliance with EMIR risk mitigation requirements:

- **Timely confirmation** – Electronic affirmation/confirmation is in place for market utilities for 'vanilla' IRS and CDS transactions.
- **Timely confirmation breach reporting** – A report and process for capturing breaches and making them available on demand to local regulators.
- **Portfolio/counterparty reconciliation** – Brokers have been notified that Aviva Investors will continue to be a receiver of data and reconcile these reports to our clients book of records.
- **Collateral Disputes** – Aviva Investors have a documented process in place and have signed and exchanged the ISDA protocol.
- **Financial / Non Financial representations** – Aviva Investors have notified counterparties of Aviva Investors clients status via Markit's portal.
- **OTC Pricing** – OTC trades priced on a daily basis using Mark to Market prices.

In addition to the above, Aviva investors has also onboarded clients to the Markit delegated reporting service for OTC trades affirmed electronically.

Aviva Investors are also on boarding clients with 2 clearing brokers (JP Morgan and Barclays) and 3 central clearing houses (Eurex, ICE and LCH) for clearing OTC derivatives in Europe, depending on instruments traded by clients.

If you would like this information in Braille, large print or audio format please contact us on **03457 24 24 24** (Minicom 0800 404 6160).



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