



PROGRAM MATERIALS

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Introduction to Derivatives for Attorneys

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Introduction to Derivatives for Attorneys

CELESQ Webinar

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A Starting Definition

A contract between two parties that provides a payoff from one party to the other to be determined at a later date, based on the uncertain future value of some asset or measurable factor, called the underlying.



What is this Underlying?

- Stock, stock price, stock index
- Interest rate
- Currency (exchange/FX) rate
- Commodity price
- Or, almost any measurable source of uncertainty, such as ... (continued)



Credit

Weather

Insurance losses

Freight/shipping rates

Cost of electricity

A quantifiable measure of volatility

Sporting events

Economic statistics

Anything uncertain and measurable



The Parties

- Buyer, long – the owner of the contract
- Seller, short (writer) – the obligor



Legal Elements of Derivatives

- Contracts
- Two parties
- Each party provides consideration, which sometimes can be *contingent*



Two General Classes of Derivatives

- Forward Commitments
- Options



Forward Commitments

- Forward contracts
- Futures contracts
- Swaps



Forward Commitments (Forward contracts)

An agreement between two parties for one party, say Party A, to buy the underlying from another party, say Party B, at a later date at a price agreed upon when the contract is created.

The parties set all contract specifications.



Forward Commitments (Forward contracts)

Example:

Tiffany & Co., a jewelry manufacturer, enters into a forward contract with a large gold producer such as Newmont Corporation, a gold mining company, to purchase 1,000 ounces of gold six months from now at a price of \$3,200 an ounce.



Forward Commitments (Forward contracts)

Note how the arrangement manages risk

What happens if gold goes up or down?

Who wins? Who loses?

Why did either party do this transaction?

Consider two possible outcomes six months later:



Forward Commitments (Forward contracts)

At expiration the price of gold is \$3,300

-Tiffany buys the gold from Newmont for \$3,200/oz. Tiffany gains, Newmont loses.

The price of gold is \$3,100

-Tiffany buys the gold from Newmont for \$3,200/oz. Newmont gains. Tiffany loses.



Forward Commitments (Forward contracts)

Tiffany got cost certainty

Newmont got price certainty

One party comes out ahead

The other party comes out behind



Forward Commitments (Futures contracts)

An agreement between two parties for one party, say Party A, to buy the underlying from another, say Party B, at a later date at a price agreed upon when the contract is created. Futures contracts have the distinct element of being standardized instruments that trade in a public market. Called a futures exchange.

The exchange sets all contract specifications except the price.



Forward Commitments (Futures contracts)

Futures contracts are subject to a daily settling of gains and losses based on the fact that their prices are determined in that public market and change as information flows over time.

They are guaranteed against credit loss by means of a clearing process.

Forward Commitments (Futures contracts)

Example

Valero buys 500 futures contracts on crude oil that expires in 30 days at a fixed price of \$98/barrel on the New York Mercantile Exchange. Each contract is for 1,000 barrels, so Valero has effectively entered into a contract for 500,000 barrels.



Forward Commitments (Futures contracts)

Who is the seller?

Dealers accommodate the buying and selling needs of outside investors.



Forward Commitments (Futures contracts)

Who might enter the market to sell?

Example: could be Chevron

Chevron and Valero are anonymous to each other



Forward Commitments (Swaps)

A series of forward contracts all at the same price or rate

The most commonly used derivative

Example: Exchange of a series of floating interest payments for a series of fixed interest payments; often used to convert a floating rate loan to a fixed rate loan



Options

An agreement between two parties in which one party pays a sum of money when the contract is created and acquires the right to buy or sell an asset at a fixed price either at a future date or during a specific future period of time.



The Two Types of Options

Calls: the right to buy the underlying

Puts: the right to sell the underlying



Characteristics of Options

Price (premium)

Exercise price (strike)

Exercise style (European or American, meaning only at expiration or the right to exercise before expiration)



Options

Example

With Apple stock at \$215 a share, an investor buys a one-month call with an exercise price of \$220 for a premium of \$4.50. The contract covers 100 shares.

The counterparty is a seller, accepting the premium and being obligated to deliver the shares if they are “called” by the buyer.



Options

What happens later:

At expiration, if Apple is above \$220, the buyer exercises the call, paying \$220 a share for 100 shares.

The buyer may or may not make enough profit to cover the premium.



Options

Or:

At expiration, if Apple is below \$220 a share, the buyer lets the option expire unexercised.

The seller gains, the buyer loses.



Options

Example

With Apple stock at \$215 a share, an investor buys a one-month put with an exercise price of \$210 for a premium of \$3.75. The contract covers 100 shares.

The counterparty is a seller, accepting the premium and being obligated to buy the shares if they are “put” by the buyer.



Options

What happens later:

At expiration, if Apple is below \$210, the buyer exercises the put, delivering the 100 shares and receiving \$210 a share.

The buyer may or may not make enough gain to cover the premium.



Options

Or:

At expiration, if Apple is above \$210 a share, the put buyer lets the option expire unexercised.

The seller gains, the buyer loses.



Options

Why use options?

Speculation

Hedging

Note: there are many sophisticated types of option strategies.



The Two Types of Derivatives Markets

- Exchange-listed (traded)
- Over-the-counter



How Derivatives are Priced

- Mathematical models assume a perfect hedge can be constructed
- Example: forward contract to buy underlying in one year that is currently selling for \$100. The one-year risk-free rate is 4%.
- The forward price would be $\$100 \times 1.04 = \104 .



How Derivatives are Priced

■ Why?

- If you bought the asset and sold a forward contract to deliver the asset in one year, you receive a 4% return.
- As this is the going rate on one-year risk-free transactions, \$104 is a fair forward price
- At any other price, arbitrageurs can enter the market and capture risk-free profits.
- Option pricing is far more complex



Option Variations

- Insurance
- Home purchase contracts
- Farm crop contracts
- Leases
- Reservations
- Rain checks
- Airline tickets
- ...



Option Variations

- Labor contracts
- Mortgage prepayment rights
- Executive and employee stock options



The Regulation of Derivatives

- Securities and Exchange Commission
- Commodity Futures Trading Commission
- Federal Reserve System
- Office of the Comptroller of the Currency
- FDIC
- FINRA
- State insurance regulators



Final Comments

- The derivatives market is huge and represents a major layer of the financial ecosystem.
- Billions of contracts trade annually
- Derivatives are often the subject of litigation.
- Many business arrangements are derivatives

