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Essays on Banking, Investment Banking, Insurance, Mutual Funds, Exchange-Traded Funds, Hedge Funds, Private Equity Funds, Securitization, Futures/Forward Contracts, and Options Contracts

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ABSTRACT: This article discusses the features of banking, investment banking, insurance, mutual funds, exchange-traded funds, hedge funds, private equity funds, securitization, futures/ forward contracts, and options contracts. The first essay outlines the qualities of the banking industry. The second essay talks about investment banking, defining both it and a broker-dealer, and then discussing the risks to the investment banking and broker-dealer businesses. The third essay outlines insurance, defines it, lists its types, reviews the regulatory structure, and discusses the challenges insurance regulators face. The fourth essay is concerned with mutual funds and exchange-traded funds. Both concepts are defined, and their characteristics are listed and compared. The fifth essay addresses hedge funds and private equity funds. Again, both are defined and their characteristics are enumerated. This essay also defines and discusses general and limited partners and the regulatory structure faced by hedge and private equity funds. The sixth essay deals with securitization, demonstrating how it works, listing the securitization steps, and comparing the advantages and disadvantages of securitization to the issuer and the investor. The final essay examines futures/forward and options contracts. Examples are provided, and the benefits of futures/forwards and options contracts are considered. The conclusion summarizes the information, noting that the financial institutions discussed have arisen due to compound interest and the omnipresent desire for profit.

KEYWORDS: • Banking •Exchange-Traded Funds •Futures/Forward Contracts •Hedge Funds •Insurance, •Investment Banking •Mutual Funds •Options Contracts •Private Equity Funds •Securitization

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LIST OF ABBREVIATIONS

Abbreviation	Description
ABS	Asset-Backed Security
AUM	Assets Under Management
CA14	Clayton Act of 1914
CBO	Collateralized Bond Obligation

CD	Certificate of Deposit
CDO	Collateralized Debt Obligation
CDO-Cubed	Tranches of CDO-Squared Securities
CDO-Squared	Tranches of other CDO Securities
CEA36	Commodity Exchange Act of 1936
CFBB	Consumer Financial Protection Bureau
CFTC	Commodity Futures Trading Commission
CLO	Collateralized Loan Obligation
CMBS	Commercial Mortgage-Backed Security
CMO	Collateralized Mortgage Obligation
Dodd-Frank	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
DoJ	Department of Justice
ETF	Exchange-Traded Fund
FCEN	Financial Crimes Enforcement Network
FDIC	Federal Deposit Insurance Company
FFIEC	Federal Financial Institutions Examination Council
FinCEN	Financial Crimes Enforcement Network
FINRA	Financial Industry Regulatory Authority
FTC	Federal Trade Commission
FTCA	Federal Trade Commission Act of 1914
GLBA	Gramm-Leach-Bliley Act of 1999
GSA	Glass-Steagall Act of 1933
IAA40	Investment Advisers Act of 1940
ICA40	Investment Company Act of 1940
IPO	Initial Public Offering
IRS	Internal Revenue Service
JOBS	Jumpstart Our Business Startups Act of 2012
M&A	Mergers and Acquisitions
MBS	Mortgage-Backed Security
MFA	McCarren-Ferguson Act of 1945
NAIC	National Association of Insurance Commissioners
NAV	Net Asset Value
OCC	Office of the Comptroller of the Currency
OTC	Over-the-Counter
PPM	Private Placement Memorandum
Reg BI	Best-Interest Regulation
RMBS	Residential Mortgage-Backed Security
S&L	Savings and Loan Association
SA90	Sherman Act of 1890
SA33	Securities Act of 1933
SEA34	Securities Exchange Act of 1934
SEC	Securities and Exchange Commission

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INTRODUCTION

This article discusses the features of banking, investment banking, insurance, mutual funds, exchange-traded funds, hedge funds, private equity funds, securitization, futures/ forward contracts, and options contracts. The first essay outlines the qualities of the banking industry. The second essay talks about investment banking, defining it, and a broker-dealer, and then discussing the risks to the investment banking and broker-dealer businesses. The third essay outlines insurance, defining it, listing its types, reviewing the regulatory structure, and the challenges faced by insurance regulators. The fourth essay is concerned with mutual funds and exchange-traded funds. Both concepts are defined and their characteristics are listed and compared. The fifth essay addresses hedge funds and private equity funds. Again, both are defined and their characteristics are enumerated. This essay also defines and discusses general and limited partners and the regulatory structure faced by hedge and private equity funds. The sixth essay deals with securitization, demonstrating how it works, listing the securitization steps, and comparing the advantages and disadvantages of securitization to the issuer and the investor. The final essay examines futures/forward and options contracts. Examples are provided and the benefits of futures/forwards and options contracts are considered. The conclusion summarizes the information contained therein, noting that the financial institutions discussed have arisen due to the existence of compound interest and the omnipresent desire for profit.

ESSAY ON BANKING

In this essay, the types of banking institutions are described. Second, the banking oversight agencies are examined. The various banking regulations are discussed. Finally, the essay observes that the regulatory requirements depend on what governmental body charters the financial institution, what is the content of the charter, and what activities do the banking entity offer. All these factors determine the regulatory and supervisory approaches. The purpose of this plethora of institutions, regulatory bodies, and federal and state regulations is to ensure the safety and stability of the United States financial system.

Types of Bank Institutions

The banking institutions discussed herein are national banks, state banks, thrift institutions, or Savings and Loan Associations (S&Ls), and credit unions. Each one will be discussed in turn.

National Banks.

In the United States, a national bank is also known as a commercial bank.[1] The Comptroller of the Currency, part of the United States Treasury, charters a national bank.[2] A national bank is a member of the Federal Reserve System and a member of a district Federal Reserve bank.[3] National banks are members of the Federal Deposit Insurance Corporation (FDIC) and participate in auctioning U.S. Treasury bonds.[4] In contrast, internationally, a national bank is another name for a country's central bank, which establishes monetary policies for that nation.[5]

State Banks

States charter a state bank to offer primarily commercial banking services.[6] A state bank is neither a national nor a central bank and does not influence the federal government's monetary policy.[7] State banks may be large financial institutions, but may not expand beyond a state's borders because they are not federally chartered.[8] State banks are limited to providing personal banking services, and in some instances, wealth management and insurance services.[9] State banks can offer Certificates of Deposit (CDs) as well as checking and savings accounts to individuals and small businesses.[10]

Thrift Institutions

A thrift institution, sometimes denoted as a thrift, is a financial entity that concentrates in providing savings accounts and home mortgages for consumers.[11]Thrifts are also known as S&Ls.[12] In contrast to national banks and savings banks, thrifts give

[1] Julia Kagan, National Bank: Meaning, History, Examples, *Investopedia* (Oct. 31, 2020), *available at* https://www.investopedia.com/terms/n/national-bank.asp.
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] *Id.*
[6] Julia Kagan, State Bank: What It Is, How It Works, Services, *Investopedia* (Jan. 29, 2021), *available at* https://www.investopedia.com/terms/s/state-bank.asp.
[7] *Id.*
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] Julia Kagan, Thrift Bank: Definition, History, How It Works, and Impact, *Investopedia* (Jul. 31, 2020), *available at* https://www.investopedia.com/terms/t/thriftbank.asp.
[12] *Id.*

higher interest payments on savings accounts while extending limited lending services to businesses.[13] S&Ls offer checking accounts, personal and automobile loans, and credit cards for consumers while primarily being involved in mortgages for single-family residences.[14] Thrifts can either be corporate entities owned by its shareholders or be owned by its depositors and borrowers.[15]

Credit Unions

Credit unions are financial non-profit cooperatives that offer traditional banking services to their members.[16] Credit unions are non-profit institutions whose members pool their money, thereby purchasing shares in the cooperative, to supply loans, checking and saving accounts, and other financial services to its members.[17] The income earned by the credit union is employed to fund beneficial community projects and the interest of members.[18] Credit unions have fewer products than traditional banking entities, but typically offer better interest rates and more ATM locations.[19] Credit unions range from small volunteer operations to large organizations that operate nationwide.[20] Large corporations sometimes form credit unions to benefit their employees.[21] Credit unions are non-profit entities and are exempt from paying corporate taxes.[22]

Banking Oversight Agencies

The United States possesses a dual banking system of federally chartered and state-chartered banks.[23] Most banks in the United States are supervised by more than one bank regulatory agency, either on the federal or state levels.[24] If the bank purchases deposit insurance, it is subject to the rules of the Federal Deposit Insurance Company (FDIC).[25] If a state bank decides to become a Federal Reserve System member, the Federal Reserve becomes the leading federal regulator.[26] Bank holding companies are responsible for banking regulation at the parent company level.[27] The regulatory agencies supervise the internal activities of national and state banks and administer the applicable federal and state banking laws. The regulatory bodies that are responsible for regulating national and state banks include:

The Federal Reserve System

The Federal Reserve is primarily responsible for regulating national and state banks. The Federal Reserve has the power to issue cease-and-desist orders, remove bank and holding company officers as well as other relevant parties, levy fines, revoke membership, and order the divestiture or termination of banking activities.[28]

The Office of the Comptroller of the Currency

The Office of the Comptroller of the Currency (OCC) is the oldest federal bank regulatory agency. It supervises national banks, savings and loan associations, and federal branches of foreign banks. The OCC is part of the U.S. Treasury. It charters national banks; reviews national bank branch merger applications; issues cease-and-desist orders; levies fines against national bank officers, directors, employees, and other associated parties that violate laws or engage in unsafe and unsound banking practices; removes or suspends national bank officials; and places national banks into conservatorship or revokes their charters.[29]

The Federal Deposit Insurance Corporation

Organized in 1934, the FDIC provides insurance on deposits at commercial banks. All Federal Reserve members are required to obtain FDIC insurance. FDIC insurance can be offered to non-member banks with the approval of the FDIC. Almost all non-member banks are insured by the FDIC. To avoid regulatory duplication, the FDIC only directly supervises state-chartered banks that are not members of the Federal Reserve System. The FDIC acts as a receiver for failed banks and manages deposit insurance funds. The insurance organization can make special examinations of its insured banks to determine their financial condition. The FDIC has the power to terminate deposit insurance; issue cease-and-desist orders; remove bank officials, directors,

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[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] Mitchell Grant, Credit Unions: Definition, Membership Requirements, and vs. Banks, *Investopedia* (Jun. 22, 2023), *available at* https://www.investopedia.com/terms/c/creditunion.asp.
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] KAREN MAN, GLOBAL FINANCIAL SERVICES REGULATORY GUIDE, BAKER & MCKENZIE 152 (n.d.), *available at* https://resourcehub.bakermckenzie.com/en/resources/global-financial-services-regulatory-guide.
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] *Id.*

and associated parties; levy fines at state-non-member banks; recommend and pursue enforcement actions; or appoint itself a conservator or receiver of the banking institution.[30]

State Banking Agencies

Each of the 50 states has a separate regulatory agency responsible for supervising state banks and foreign banks located within the state. State banks must adhere to all applicable state laws and regulations. State banking agencies issue bank charters; conduct bank examinations; create and enforce bank regulations; and approve branch and merger applications. State banking agencies can also revoke a state bank's charter; issue cease-and-desist orders; remove bank officials; and levy fines.[31]

Other Regulators

Various other state and federal regulatory agencies are responsible for supervising U.S. banks. Some of the more critical agencies include the Consumer Financial Protection Bureau (CFPB), the Financial Crimes Enforcement Network (FCEN), the Federal Financial Institutions Examination Council (FFIEC), the Department of Justice (DoJ), and the Federal Trade Commission (FTC). Financial institutions that engage in securities and investment-related activities are regulated by the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority, Inc. (FINRA), and the state securities agencies. If a bank deals with derivatives, it is regulated by the Commodity Futures Trading Commission (CFTC), which involves the supervision of futures contracts, options on futures contracts, swaps, leveraged retail foreign exchange and commodity contracts, and other leveraged products. If a bank is involved with insurance, state commissioners have general regulatory authority, and the entity must behave in conformance with state licensing laws and other state insurance laws and regulations. Finally, the states are responsible for licensing money transmission services. Banks that transfer money for their customers must register with the federal government via the Financial Crimes Enforcement Network (FinCEN), and are subject to various anti-money laundering requirements contained in the Bank Secrecy Act.[32]

Banking Regulations

There are many banking regulations in the United States. The purpose of these regulations is to protect the money of individuals and businesses and to ensure that banking customers are treated fairly and equitably. The regulations include:[33]

- ***Regulation B: Equal Credit Opportunity*** – Prohibits lenders from discriminating against credit applicants.
- ***Regulation C: The Home Mortgage Disclosure Act*** – Requires financial institutions to maintain and annually disclose information about home purchases, home purchase pre-approvals, home improvement, and refinance applications involving one- to four-unit and multifamily dwellings.
- ***Regulation D: Reserve Requirements of Depository Institutions*** – Establishes uniform reserve balance requirements with the district Federal Reserve Bank or as cash. The regulation also defines withdrawal limitations from savings, money markets, and CDs.
- ***Regulation E: Electronic Fund Transfers*** – States the rights, liabilities, and responsibilities of the parties involved in electronic funds transfers.
- ***Regulation G: SAFE Mortgage Licensing Act*** – Created the licensing and registration requirements for all mortgage loan originators.
- ***Regulation J: Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers Through Fedwire*** – Oversees the guidelines for processing checks and other cash instruments for individuals and financial organizations.
- ***Regulation M: Consumer Leasing***—This regulation applies to the Truth in Lending Act consumer leasing provisions by mandating that the leasing terms be fully disclosed.
- ***Regulation V: Fair Credit Reporting*** – Establishes collecting, sharing, and using consumer credit information. It permits customers to get a copy of their credit report from various credit bureaus such as Equifax, Experian, and Trans Union. The regulation allows consumers to challenge negative information. Regulation V also sets the time limit for removing negative information from a credit report. Finally, the regulation requires entities to inform consumers when an unfavorable action occurs based on the information in the credit report.
- ***Regulation Z: Truth In Lending*** – Stipulates uniform methods for computing the cost of credit, disclosing credit terms, and correcting errors on specific types of credit accounts. These methods must be revealed to a borrower before giving credit for loans, including how a financial entity advertises.

[30] *Id.* at 152-53.
[31] *Id.*
[32] *Id.*
[33] BTC Staff, Banking Regulations, *Bank Training Center* (n.d.), *available at https://www.banktrainingcenter.com/banking-regulations.*

- ***Regulation CC: Availability of Funds and Collection of Checks*** – Regulates how and when checking account funds are available and the conditions when holds can be placed on checking account funds, the maximum amount of time a hold can exist, and the return of checks.
- ***Regulation DD: Truth In Savings*** – Specifies the disclosure of the terms and conditions for interest and fees and the opening of new savings accounts.

Advantages to the Stability and Safety of the Financial System

Based on the information above, different types of financial institutions engage in various banking activities. The entities can be chartered by the federal government or by the states. Depending on the governmental body that charters a financial institution, certain legal requirements are expected to be fulfilled. If the federal government charters a national bank, then that bank must become a member of the Federal Reserve System. If a state charters a banking company, then that entity is required to obey state laws as well as federal laws.

The regulatory bodies that a banking institution must report to depend on federal and state laws and the activities in the charter. For example, thrifts are regulated by the OCC and various state agencies. If the thrift purchases deposit insurance, it is also regulated by the FDIC. The regulations that banking institutions must follow depend on what services an entity offers. If an institution offers home mortgages, it is subject to Regulations B, C, G, M, V, and Z. If a banking organization offers checking and savings accounts, it must follow at least Regulations CC and DD. If a banking institution is a member of the Federal Reserve System, it must adhere to the Fed's reserve requirements, and if it is a state financial institution, it must also follow the state's reserve requirements.

The key criteria are what governing body charters the banking institution, what is contained in the charter, and what services the organization offers. These factors determine the regulating bodies and regulations the organization must follow. It is a complex situation with a byzantine answer. The American financial system is multifaceted and thus demands a regulatory approach that considers the intricate details of the system. In other words, there is no royal road to maintaining the safety and stability of the United States financial system.

Conclusion – Essay on Banking

In conclusion, this essay introduces the banking industry and the government agencies that regulate it. The purpose of the text is to outline the various parts of banking so that the succeeding essays become more relevant. This essay and the essays to follow will provide the reader with a reasonably detailed understanding and appreciation of the financial sector so that one can make sense of the financial world around us.

ESSAY ON INVESTMENT BANKING

This essay describes the risks and abuses in the investment banking and broker-dealer business. First, investment banking and broker-dealers are defined. Second, the risks and abuses in the investment banking business are discussed. Third, the risks and abuses in the broker-dealer business are explained. Finally, the piece concludes by observing that there are a myriad number of risks and abuses that exist in both businesses. The idea is to mitigate the risks and avoid the abuses so that these companies can operate effectively and satisfy the desires of their customers.

Definition of Investment Banking

According to Kagan, investment banking is "a type of banking that organizes large, complex financial transactions such as mergers or initial public offering (IPO) underwriting."[34] Vipond defined investment banking as "the division of a bank or financial institution that serves governments, corporations, and institutions by providing underwriting (capital raising) and mergers and acquisitions (M&A) advisory services."[35] Investment banks are intermediaries between investors and corporations that require capital to grow and operate a business.[36] Investment banks raise money by underwriting new securities for firms, municipalities, and other entities.[37] These organizations also may manage a corporation's IPOs and advise on mergers, acquisitions, and reorganizations.[38] In essence, investment bankers help their clients through the maze of high finance.[39]

[34] Julia Kagan, Investment Banking: What It Is and What Investment Bankers Do, *Investopedia* (Aug. 6, 2024), *available at* https://www.investopedia.com/terms/i/investment-banking.asp.
[35] Tim Vipond, Investment Banking Overview, *Corporate Finance Institute* (n.d.), *available at* https://corporatefinanceinstitute.com/resources/career/investment-banking-overview/.
[36] *Id.*
[37] Julia Kagan, *supra*, note 34.
[38] *Id.*
[39] *Id.*

Definition of a Broker-Dealer

According to the SEC, a broker/dealer is "any person engaged in the business of buying or selling securities for the account of others."[40] In other words, a broker/dealer is any individual or organization whose business is the buying and selling of securities, but not necessarily for their own account.[41] According to Hayes, a broker/dealer is a "person or firm in the business of buying and selling securities for its own account or on behalf of its customers."[42] The term broker/dealer describes a stock brokerage house because these companies can act as both agents and principals. A broker/dealer acts as a broker when it buys and sells securities on behalf of its clients, whereas it acts as a dealer when it buys and sells securities for its account.[43] According to Black's Law Dictionary, a broker/dealer is a "brokerage firm that engages in the business of trading securities for its own account (i.e., as a principal) before selling them to customers."[44] A broker/dealer is usually registered with the SEC and in the states where it does business.[45]

Risks and Abuses in the Investment Banking Business

This section is divided into two subsections. The first subsection addresses risks and the second deals with abuses in the investment banking business. Each topic will be discussed in turn.

Risks in the Investment Banking Business

The risks involved in investment banking include country, credit, currency, horizon, interest rate, liquidity, market, model, and operational risks. Country risk concerns the risk that a country will not honor its financial commitments.[46] It applies to a country's stocks, bonds, mutual funds, options, and futures. This risk exists in emerging markets or countries experiencing a significant deficit.[47] Credit risk occurs when "borrowers or counterparties fail to meet contractual obligations."[48] For example, credit risk happens when a borrower defaults on the principal and interest loan payment or fails to meet its obligation under a derivative contract.[49] Currency risk is also known as exchange rate risk.[50] It is associated with the likelihood of a declining return due to the depreciation of a currency, particularly in international investments.[51]

Horizon risk is the risk that an "investment time horizon may be unexpectedly shortened."[52] For example, if an individual loses their job, they have to sell their house unexpectedly, thereby losing money.[53] Interest rate risk arises from "unanticipated fluctuations in the interest rates due to monetary policy measures undertaken by the central bank."[54] The yields are equalized across all markets due to adjustments in supply and demand. This risk is affiliated with fixed-income securities which can affect investment banking.[55] Liquidity risk is concerned with the ability of an investment bank to meet its financial obligations.[56] This risk is associated with bank runs, where investors may lose confidence in an investment bank. Liquidity risks stem from an overreliance on short-term sources of funds, concentrated illiquid assets, mismanagement of asset-liability durations, or loss of confidence.[57]

Market risk happens due to an investment bank's actions in capital markets.[58] The causes of market risk are the unpredictability of equity markets, commodity prices, interest rates, and credit spreads. Investment banks may experience substantial

[40] SEC Staff, What Is a Broker/Dealer?, *U.S. Securities and Exchange Commission: Office of the Advocate for Small Business Capital Formation* (n.d.), *available at* https://www.sec.gov/files/oasb-broker-dealer-building-block.pdf.
[41] *Id.*
[42] Adam Hayes, What Is a Broker-Dealer (B-D), and How Does It Work?, *Investopedia* (Mar. 3, 2024), *available at* https://www.investopedia.com/terms/b/broker-dealer.asp.
[43] *Id.*
[44] BRYAN A. GARDNER (ED. IN CHIEF), BLACK'S LAW DICTIONARY 205 (Thompson West 8th ed. 1999).
[45] *Id.*
[46] James Chen, Risk: What It Means in Investing, How to Measure and Manage It, *Investopedia* (May 16, 2024), *available at* https://www.investopedia.com/terms/r/risk.asp.
[47] *Id.*
[48] CFI Team, Major Risks for Banks, *Corporate Finance Institute* (n.d.), *available at* https://corporatefinanceinstitute.com/resources/career-map/sell-side/risk-management/major-risks-for-banks/.
[49] *Id.*
[50] CFI Team, Market Risk, *Corporate Finance Institute* (n.d.), *available at* https://corporatefinanceinstitute.com/resources/career-map/sell-side/capital-markets/market-risk/.
[51] *Id.*
[52] OSC Staff, What Is an Investment Time Horizon?, *Ontario Securities Commission* (Jul. 30, 2024), *available at* https://www.getsmarteraboutmoney.ca/learning-path/understanding-risk/what-is-an-investment-time-horizon/.
[53] *Id.*
[54] CFI Team, *supra*, note 50.
[55] *Id.*
[56] CFI Team, supra, note 48.
[57] *Id.*
[58] *Id.*

exposure if they are heavily invested in capital markets or sales and trading.[59] Model risk is associated with employing "financial models to make investment decisions, evaluate risks, or price financial instruments."[60] This risk follows when a financial model is predicated on incorrect assumptions, data, or methodologies that result in potential adverse financial consequences. Model risk can be mitigated by periodically validating and reviewing financial models and cross-checking predictions.[61] Finally, operational risk is a type of business risk that deals with the uncertainties and hazards that may exist due to day-to-day business activities.[62] Operational risk can be caused by breakdowns in internal procedures, people, and systems in contrast to external forces such as political or economic events. Operational risk can be mitigated by focusing on an entity's staff, systems, and internal controls to reduce financial losses.[63]

Abuses in the Investment Banking Business

The investment banking industry is notorious for its grueling work culture, where junior bankers often work over 100 hours per week to be noticed by managers to advance their careers.[64] Junior bankers are frequently given mundane and time-consuming tasks to ensure they remain at the office until late at night. There is intense competition, constant deadlines, an aggressive atmosphere, a high-stress environment, and little work-life balance. Young investment bankers frequently burn out and are hospitalized with heart conditions, where there has been a 10 percent increase in cardiac arrest among investment bankers under 30.[65] To mitigate the stress and sleep deprivation, investment bankers may use performance-enhancing drugs, which exacerbate their health issues.[66] Thus, the investment banking culture makes it difficult for investment banks to retain talented employees.

Risks and Abuses in the Broker-Dealer Business

This section is divided into two subsections. The first subsection addresses risks and the second deals with abuses in the broker-dealer business. Each topic will be discussed in turn.

Risks in the Broker-Dealer Business

Broker-dealers confront several risks, including regulatory, cybersecurity, and compliance risks. Regulatory risks include insider trading, market manipulation, material weaknesses, and best-interest regulation risks. Cybersecurity risks include cyber-attacks and data breaches. Finally, compliance risks concern compliance programs that protect investors from fraudulent activities.

Insider trading occurs when a firm's securities are traded by individuals who have access to confidential or material, non-public information.[67] When such trading happens, an individual breaches their fiduciary duty. The SEC demands that corporate officers, directors, or other company members with access to privileged information report their trading activities. Under federal law, an insider is defined as owning at least 10 percent of a firm's securities.[68]

Market manipulation intentionally influences the supply, demand, or both of a security to mislead investors. The idea is to deceive investors into believing that a security behaves in a specific way and then profit from their ignorance.[69] A material weakness is a deficiency, or sequence of deficiencies, in a company's internal controls such that there is a reasonable likelihood that a non-compliance exists.[70] The best-interest regulation (Reg BI) is an SEC rule that requires that broker-dealers act in the best interest of

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[59] *Id.*
[60] James Chen, *supra*, note 46.
[61] *Id.*
[62] Troy Segal, Operational Risk: Overview, Importance, and Examples, *Investopedia* (Sep. 24, 2024), *available at* https://www.investopedia.com/terms/o/operational_risk.asp.
[63] *Id.*
[64] Jack Kelly, The Dark Side Of Investment Banking: Stress, Pressure And 100-Hour Workweeks, *Forbes* (May 30, 2024), *available at* https://www.forbes.com/sites/jackkelly/2024/05/30/the-dark-side-of-investment-banking-stress-pressure-and-100-hour-workweeks/.
[65] *Id.*
[66] *Id.*
[67] LII Staff, Insider Trading, *Legal Information Institute* (Feb. 2022), *available at* https://www.law.cornell.edu/wex/insider_trading#:~:text=Insider%20trading%20is%20the%20trading,of%20the%20individual's%20fiduciary%20duty%20.
[68] *Id.*
[69] Dori Zinn, What Is Market Manipulation and How Does it Happen?, *Smart Asset* (Jan. 2, 2025), *available at* https://smartasset.com/investing/market-manipulation.
[70] LII Staff, 17 CFR § 240.17a-5 - Reports to Be Made by Certain Brokers and Dealers, *Legal Information Institute* (n.d.), *available at* https://www.law.cornell.edu/cfr/text/17/240.17a-5#:~:text=A%20material%20weakness%20is%20a,non-compliance%20to%20a%20material.

their clients when providing investment advice.[71] The SEC implemented Reg BI in 2020, where before 2020, broker-dealers were only required to satisfy the less stringent suitability standard created by the FINRA before recommending a security to a client.[72]

A cyber-attack is "[a]ny kind of malicious activity that attempts to collect, disrupt, deny, degrade, or destroy information system resources or the information itself."[73] A cyber-attack originates from cyberspace and targets a firm's use of cyberspace to disrupt, disable, destroy, or maliciously control the entity's computing environment or infrastructure and either destroy or steal the company's confidential information.[74] This is known as a data breach. A compliance risk is associated with a compliance program and happens when a broker-dealer engages in fraudulent activities that result in customer financial losses. A broker-dealer may be liable for criminal or civil penalties when a violation exists.[75]

Abuses in the Broker-Dealer Business

The various broker-dealer abuses include:[76] [77]

- Recommending to a retail customer a securities transaction, investment strategy, or type of account that is not in the best interest of that customer, given the customer's age, financial situation, investment objective, risk tolerance, liquidity needs, and investment experience;
- Purchasing or selling securities in a customer's account without first receiving customer authorization;
- Switching a customer from one mutual fund to another without a legitimate investment purpose;
- Misrepresenting or failing to disclose material facts concerning an investment;
- Removing funds or securities from a customer's account without customer authorization;
- Charging a customer excessive markups, markdowns, or commissions;
- Guaranteeing customers that they will not lose money on a securities transaction;
- Trading ahead is a practice that involves placing an order for the firm's account before entering a customer's limit order, and without having a valid exception;
- Failure by a market maker to display a customer limit order in its published quotes, without a valid exception;
- Failing to use reasonable diligence to see that a customer's order is executed at the best possible price, given existing market conditions;
- Purchasing or selling a security while possessing material, non-public information about an issuer; or
- Using manipulative, deceptive, or other fraudulent methods to induce or transact a security.

Conclusion – Investment Banking Essay

In conclusion, both investment bankers can experience a plethora of risks and can commit a variety of abuses. The moral of the story is that investment bankers and broker-dealers must be vigilant to ensure that they minimize their risks and avoid abusive behavior that may have serious legal consequences for themselves and their clients.

ESSAY ON INSURANCE

This essay discusses the regulatory nuances of the insurance industry. It defines insurance, and it describes the four types of insurance: life, health, property, and casualty. The piece gives examples of insurance companies that are currently in business. The essay then reviews the regulatory structure of the insurance industry, evaluating licensing, solvency, and premium rate regulation issues. The National Association of Insurance Commissioners (NAIC) activities are also briefly outlined, noting that the organization is responsible for providing model rules and regulations for state insurance departments. Finally, the essay observes that with the repeal of the Glass-Steagall Act (GSA) of 1933 and the passage of the Gramm-Leach-Bliley Act (GLBA) of 1999, the distinction between the traditional insurance business and the commercial and investment banking business has been blurred. When banks are

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[71] Peter Gratton, Regulation Best Interest (BI): Definition, Broker Obligations, *Investopedia* (Aug. 24, 2024), *available at* https://www.investopedia.com/what-is-the-sec-s-regulation-bi-best-interest-rule-4689542.
[72] *Id*.
[73] NIST Staff, Cyber Attack, *National Institute of Standards and Technology* (n.d.), *available at* https://csrc.nist.gov/glossary/term/cyber_attack.
[74] *Id.*
[75] Leila Shaver, The Role of Broker-Dealer Compliance Programs, *My RIA Lawyer* (n.d.), *available at* https://www.myrialawyer.com/broker-dealer-compliance-programs/#:~:text=Broker-dealer%20compliance%20programs%20have,criminal%20penalties%20and%20financial%20losses.
[76] Jon Eisenberg, & K. L. Gates, SEC Enforcement Actions Against Broker-Dealers, *Harvard Law School Forum on Corporate Governance* (Dec. 26, 2015), *available at* https://corpgov.law.harvard.edu/2015/12/26/sec-enforcement-actions-against-broker-dealers/.
[77] FINRA Staff, Prohibited Conduct, *Financial Industry Regulatory Authority* (n.d.), *available at* https://www.finra.org/investors/investing/working-with-investment-professional/prohibited-conduct#:~:text=Removing%20funds%20or%20securities%20from,or%20sale%20of%2C%20a%20security.

only involved in traditional banking business, they are subject to federal law, whereas insurance companies are now exposed to both federal and state laws, depending on their business activities. This is the current nature of the insurance industry.

Definition of Insurance

According to Nissim, insurance is a financial instrument that provides "economic protection from identified risks occurring or discovered within a specified period."[78] Kagan defined insurance as a "contract, represented by a policy, in which a policyholder receives financial protection or reimbursement against losses from an insurance company."[79] An insurance company pools the risks of its clients or customers to make the payments, known as premiums, to be affordable.[80] Many individuals purchase insurance for their automobiles, houses, healthcare, and lives. Insurance is a unique product because the ultimate cost of insurance can only be known statistically, while the revenue is received before or during the coverage period.[81]

Types of Insurance Companies

The four types of insurance are life, health, property, and casualty insurance.[82] Life insurance is a contract or policy that guarantees that the insurance company or insurer pays the beneficiary (typically a spouse or children) of an individual a specific sum of money if the individual dies within the coverage period.[83] In exchange, an individual pays premiums to the insurer during the coverage period while the individual is alive.[84] The two types of life insurance are term insurance, which covers an individual for a specific period, such as 5, 10, or 20 years, and permanent life insurance, which covers an individual throughout their life as long as they pay the premiums.[85]

Health insurance covers routine and emergency costs of medical care, sometimes including vision and dental care.[86] An annual deductible is typically paid by the insured, known as a copay. The copay can be a fixed amount or a percentage of the medical benefit that was covered. Health insurance sometimes provides preventative services that may be covered independent of the deductible.[87] Health insurance may be purchased from an insurance company via an insurance agent, the federal Health Insurance Marketplace, provided by an employer, or directly from Medicare or Medicaid.[88]

Property insurance covers property (real or personal) owners or renters. Examples of property insurance include homeowners, renters, flood, hurricane, or tornado insurance. These policies cover damages caused by fire, flooding, theft, vandalism, weather, etc.[89] A typical homeowner insurance policy will likely not cover floods or earthquakes. A separate contract, known as an insurance rider, may increase coverage for specific events at an increased premium amount.[90]

Casualty insurance is a diverse collection of insurance coverage for individuals and businesses against property loss, damage, and additional liabilities.[91] Casualty insurance encompasses automobile liability and theft insurance, where losses are losses due to an insured's interaction with other individuals or their property.[92] Homeowners and auto owners should have casualty insurance because damages can be expensive. Casualty insurance also includes aviation insurance, workman's compensation, and surety bonds.[93]

Examples of Insurance Companies

Examples of insurance companies include Berkshire Hathaway Inc., Allstate Corp., The Travelers Companies Inc., Prudential Life Insurance Co., Ace Limited, Liberty Mutual Insurance Co., The Chubb Corporation, Progressive Corp., United

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[78] Doron Nissim, Analysis and Valuation of Insurance Companies, *Columbia Business School: Center for Excellence in Accounting and Security Analysis* 3 (Nov. 2010), *available at* www.columbia.edu/~dn75/Analysis%20and%20Valuation%20of%20Insurance%20Companies%20-%20Final.pdf.
[79] Julia Kagan, Insurance: Definition, How It Works, and Main Types of Policies, *Investopedia* (Nov. 26, 2024), *available at* https://www.investopedia.com/terms/i/insurance.asp.
[80] *Id.*
[81] Doron Nissim, *supra*, note 78 at 3.
[82] *Id.*
[83] Julia Kagan, *supra*, note 79.
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] *Id.*
[89] *Id.*
[90] *Id.*
[91] Julia Kagan, Casualty Insurance: Definition, Types, and Examples, *Investopedia* (Aug. 7, 2023), *available at* https://www.investopedia.com/terms/c/casualtyinsurance.asp.
[92] *Id.*
[93] *Id.*

Health Group, and CNA Financial Corp. Some insurance companies sell life, health, property, and casualty insurance, such as American International Group Inc., Hartford Financial Services Group Inc., and Assurant Inc.[94]

Regulatory Structure of Insurance Companies

The states regulate insurance companies as opposed to the federal government.[95] The system of regulation originates from the McCarran-Ferguson Act (MFA) of 1945, which states that state regulation of insurance companies is in the public interest and gives state regulators preeminence over federal law.[96] The Act exempts insurance company practices from federal antitrust laws, such as the Sherman Act (SA90) of 1890, the Clayton Act (CA14) of 1914, and the Federal Trade Commission Act (FTCA) of 1914.[97] The MFA was passed in response to the Supreme Court's ruling in *South-Eastern Underwriters Association*, where the Court opined that insurance was subject to federal regulation.[98] [99]

An insurance company must be licensed in a state before it can sell insurance in that state.[100] When an insurance company is licensed in a state, it is said to be admitted to that state. An insurance company is domiciled in the state that issued its primary license. If an insurance company does business in another state, it is a foreign insurer. Insurance companies that are licensed in other countries are known as alien insurers.[101] All insurance companies are subject to capital and surplus requirements which vary from state to state. For example, New York State possesses a $500,000 capital requirement and a $250,000 surplus requirement. In Wyoming, there are different requirements, depending on whether the firm is a mutual or stock company.[102]

The states also regulate the solvency of an insurance company.[103] State regulators oversee an insurance company's financial health by requiring the organization to provide detailed annual financial statements, which are due on March 1. The statutory audited financial statements are generally due June 1.[104] If an insurance company becomes insolvent, state regulators can take various actions, including requiring other insurance companies to assume specific lines of business.[105] All states have created organizations known as guaranty funds, through which property and casualty insurance companies can cover claims against insolvent insurers.[106] When insolvency occurs, claims are assessed based on the amount of business done in a state. The only exception is that surplus line insurers are typically not part of the guaranty fund system.[107] Guaranty funds cover homeowners, cars, and workers' compensation claims, while other kinds of insurance may not be included.[108]

States differ significantly when regulating premium rates.[109] Some states permit insurers to be independent of rate regulation when dealing with corporations of specific size and sophistication, where the size range varies by state. The three principles that underlie state rate regulations are:[110]

- The rates must be adequate to ensure solvency;
- Not too high to lead to excessive profits; and
- Not unfairly discriminatory where price differences reflect expected claims and expenses.

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[94] Doron Nissim, *supra*, note 78 at 3.
[95] III Staff, Regulation, *Insurance Information Institute* (n.d.), *available at* https://www.iii.org/publications/commercial-insurance/how-it-functions/regulation#:~:text=Regulation-,Introduction,set%20of%20statutes%20and%20rules.
[96] *Id.*
[97] Michael G. Cowie, Health Insurance and Federal Antitrust Law: An Analysis of Recent Congressional Action, *The Antitrust Source* (Dec. 2009), *available at* https://www.kff.org/wp-content/uploads/sites/3/2011/09/dec09_cowie12_17f.authcheckdam.pdf.
[98] *Id.*
[99] *United States v. South-Eastern Underwriters Association*, 322 U.S. 533 (1944), *available at* https://supreme.justia.com/cases/federal/us/322/533/.
[100] III Staff, *supra*, note 95.
[101] *Id.*
[102] *Id.*
[103] *Id.*
[104] PWC Staff, 13.1 Statutory Accounting and Reporting Overview, *Price Waterhouse Cooper* (Jan. 31, 2021), *available at* https://viewpoint.pwc.com/dt/us/en/pwc/accounting_guides/insurance-contracts/Insurance-Contracts/Ch13_statutory_accounting/13_1statutoryaccounting.html.
[105] III Staff, *supra*, note 95.
[106] *Id.*
[107] *Id.*
[108] *Id.*
[109] *Id.*
[110] *Id.*

To ensure that these principles are followed, insurance premium rates must either be approved before they can be used or be competitive. This does not mean that insurance companies do not compete with each other. In contrast, most insurance companies have premium rates that are below a state's prior approval ceiling.[111]

Finally, the NAIC is responsible for generating model rules and regulations for the insurance industry. Many of these are approved by state legislatures before being implemented.[112] In the 1980s, the NAIC developed an accreditation program for state insurance departments and originated minimum capital requirements for insurance companies based on the risks they incurred.[113] These rules and regulations promote an orderly regulatory atmosphere at the state level.

Challenges in the Regulatory Structure

With the repeal of the GSA and the passage of the GLBA, insurance companies can now engage in commercial and investment banking transactions.[114] [115] This means that when an insurance company acts as a commercial or an investment bank, it is subject to federal law, including the Securities Act (SA33) of 1933, the Securities Exchange Act (SEA34) of 1934, and the Investment Company Act (ICA40) of 1940. The challenge currently facing federal and state regulators is to determine when an insurance company is acting traditionally as an insurance company and not subject to federal regulation, and when a company is acting as a commercial or investment banker, where the firm is subject to federal law. This distinction can be challenging to resolve, mainly when an insurance company is providing products to its customers that may look like insurance policies from one perspective, but also appear to be commercial and investment banking products from another point of view. This comingling of perspectives can be daunting for federal and state regulators, mainly when jurisdiction is an issue. Although federal and state agencies regulate banking institutions, insurance companies are regulated by the states when they engage in pure insurance business, but may also be regulated by the same federal agencies as banks and other financial institutions when they act as commercial or investment bankers.

Conclusion – Insurance Essay

In conclusion, this essay discussed the regulatory nuances of the insurance industry. It defined insurance and described the four types: life, health, property, and casualty. The piece gave examples of insurance companies currently in business. The essay then reviewed the regulatory structure of the insurance industry, evaluating licensing, solvency, and premium rate regulation issues. The activities of the NAIC were also briefly highlighted, noting that the organization is responsible for providing model rules and regulations for state insurance departments.

Finally, the essay observed that as long as insurance companies remain pure insurance companies and do not cross into the realm of commercial and investment banking, it is immune from federal regulation via the McCarran-Ferguson Act of 1945. However, as soon as an insurance company dips its toe into commercial and investing banking waters, it becomes subject to a host of federal banking regulations. The issue facing federal and state regulators is figuring out when an insurance company is acting as a traditional insurance company, and acting as a commercial or investment banker. This can be no mean feat, mainly when the firm combines the two business processes. No crystal ball can be used to distinguish the two activities. Care must be taken. Insurance companies as well as federal and state regulators can make mistakes. GLBA muddied the waters, and there is no going back to the GSA. This is an unfortunate situation, that is for sure.

ESSAY ON MUTUAL FUNDS AND EXCHANGE TRADED FUNDS

This essay discusses the differences between mutual funds and exchange-traded funds (ETFs). First, mutual funds and ETFs are defined. Second, the characteristics and differences between mutual funds and ETS are listed and then highlighted. Third, the advantages and disadvantages of ETFs are enumerated. Finally, the piece concludes by observing that before an investor can make the appropriate decision of whether to invest in a mutual fund or an ETF, they should consider both their short-term objectives and long-term goals. Only then can a proper decision be made.

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[111] *Id.*
[112] *Id.*
[113] *Id.*
[114] FTC Staff, Gramm-Leach-Bliley Act, *U.S. Federal Trade Commission* (n.d.), *available at* https://www.ftc.gov/business-guidance/privacy-security/gramm-leach-bliley-act#:~:text=The%20Gramm-Leach-Bliley%20Act,and%20to%20safeguard%20sensitive%20data.
[115] TDI Staff, Gramm-Leach-Bliley Resource Page, *Texas Department of Insurance* (Feb. 8, 2024), *available at* https://www.tdi.texas.gov/webinfo/privacy2.html.

Definition of a Mutual Fund

According to Hayes, mutual funds are "pooled investments managed by professional money managers" that "trade on exchanges and provide an accessible way for investors to access a wide mix of assets selected for the fund."[116] A mutual fund combines the money from many investors to buy a diversified portfolio of stocks, bonds, and other securities so that individuals may save for their retirement in a manner that would be difficult to achieve alone.[117] FINRA observed that mutual funds are "open-end funds, meaning that investors can purchase and redeem shares in the funds daily based on the net asset value (NAV) of their shares."[118] Although mutual funds are a common method of investing in securities because they offer specific advantages, investors may still lose money.[119]

Definition of an Exchange Traded Fund

According to Chen, an ETF is an "investment vehicle that pools a group of securities into a fund," and "can be traded like an individual stock on an exchange."[120] An ETF can track a commodity's price, an extensive portfolio of diversified stocks, or even specific investment strategies.[121] Investors may employ ETFs for income generation, speculation, or risk hedging.[122] According to the Fidelity Staff, an ETF is a "type of investment fund that is also an exchange-traded product, i.e., it is traded on stock exchanges."[123] ETFs consist of stocks, bonds, currencies, debts, futures contracts, or commodities such as gold bullion.[124]

Characteristics and Differences Between a Mutual Fund and an Exchange Traded Fund

The characteristics of a mutual fund are:[125]

- Annual expense fees range from 0.2 percent to 1.0 percent of the value of the investment;
- Diversified stock and bond portfolios managed by finance professionals;
- Fund share prices are established at market close based on the net asset value (NAV) of all holdings minus expenses divided by total shares;
- Mutual funds are **not** subject to section 31 of SEA34, which as of February 2023, is $8 per $1 million in transaction proceeds;
- Investment companies do not charge commission fees for the purchase and sale of no-load mutual funds, but may charge commissions for loaded funds;
- Mutual funds are bought and sold only through the investment company managing a fund;
- Shareholders who hold the fund in taxable accounts often pay capital gains taxes on their share of the gain; and
- Many individuals invest in mutual funds through employee retirement plans such as 401K or IRA accounts.

The characteristics of an ETF include:[126]

- Annual expense fees range from 0.2 percent to 1.0 percent of the value of the investment;
- ETFs may be managed by finance professionals;
- ETF share prices fluctuate throughout the trading day;
- ETFs in the United States are subject to transaction fees under section 31 of the SEA34;
- Stockbrokers may charge commission fees for the purchase and sale of ETFs;
- ETFs trade on a stock exchange where they can be (1) sold short, (2) purchased on margin, and (3) purchased and sold using limit orders;
- ETF investors only realize and pay taxes on capital gains when they sell their shares for a gain; and

[116] Adam Hayes, Investing in Mutual Funds: What They Are and How They Work, *Investopedia*, (Jan. 30, 2025), *available at* https://www.investopedia.com/terms/m/mutualfund.asp.
[117] *Id.*
[118] FINRA Staff, Mutual Funds, *Financial Industry Regulatory Authority* (2025), *available at* https://www.finra.org/investors/investing/investment-products/mutual-funds.
[119] *Id.*
[120] James Chen, Exchange-Traded Fund (ETF): How to Invest and What It Is, *Investopedia* (Aug. 1, 2024), *available at* https://www.investopedia.com/terms/e/etf.asp.
[121] *Id.*
[122] *Id.*
[123] Fidelity Staff, What Is an ETF?, *Fidelity Investments* (n.d.), *available at* https://www.fidelity.com/learning-center/smart-money/what-are-etfs.
[124] *Id.*
[125] Wikipedia Staff, Exchange Traded Fund, *Wikipedia.org* (Jan. 27, 2025), *available at* https://en.wikipedia.org/wiki/Exchange-traded_fund.
[126] *Id.*

- Some individuals invest in ETFs through employee retirement plans such as 401K or IRA accounts.

Based on the above characteristics, the first two characteristics of mutual funds and ETFs are essentially the same. For mutual funds, the fund share prices are determined at the end of a trading day, whereas for ETFs, the share prices fluctuate throughout the trading day. Mutual funds are not subject to section 31 of the SEA34, whereas ETFs are subject to section 31. As of February 2023, the fee paid to the SEC is $8 per $1 million in transaction proceeds.

There are no commission fees on no-load mutual funds while commissions can be charged on loaded funds. In contrast, stockbrokers may charge commission fees on the purchase and sale of ETFs. Mutual funds are bought and sold through the investment company managing a fund, whereas ETFs can be traded on a stock exchange, sold short, purchased on margin, and via limit orders. It was observed that with taxable mutual fund accounts, investors pay taxes on their share of the gain, while ETF investors only realize and pay taxes on capital gains when they sell their shares for a gain. Finally, mutual funds and ETFs can be held in employment retirement plans such as 401K or IRA accounts.

Advantages and Disadvantages of an Exchange-Traded Fund

According to Segal, the advantages of an ETF are:[127]

- ***Diversification*** – An ETF investor can be exposed to different securities from a particular industry, investment category, country, or market index thereby reducing risk;
- ***Trades Like a Stock*** – The buying and selling of an ETF assures that an investor knows approximately the purchase and sale price, whereas with a mutual fund the purchase or sale is known only at the end of the day;
- ***Lower Fees*** – ETFs are passively managed and tend to possess lower expense ratios than mutual funds;
- ***Immediately Reinvested Dividends*** – Dividends of open-ended ETFs are reinvested immediately, whereas, for index mutual funds, the exact timing for reinvestment can vary;
- ***Limited Capital Gains Tax*** – ETFs can be more tax-efficient than mutual funds because they are passively managed, while mutual funds are actively managed; and
- ***Lower Discount or Premium in Price*** – There is a very small probability of an ETF share price being higher or lower than the share price of the underlying shares.

Segal also observed that the disadvantages of ETFs are:[128]

- ***Less Diversification*** – For some sectors or foreign stocks, investors could be limited to large-cap stocks because the equity groups are narrow, thereby limiting potential growth opportunities available in mid-cap and small-cap companies;
- ***Intraday Pricing Might Cause Unwise Trading*** – Long-term investors typically possess time horizons of ten to 15 years or more, so significant price movements in a day could induce unnecessary trading;
- ***Costs Could Be Higher*** – When ETF trading is compared with investing in specific stocks, the ETF costs are usually higher because management fees are charged for ETF securities;
- ***Lower Dividend Yields*** – Although dividend-paying ETFs exist, the yields are typically not as high as owning a specific stock, even though the risks of owning an ETF are usually lower than owning a given stock;
- ***Skewed Leveraged ETF Returns*** – A leveraged ETF is a fund that employs financial derivatives and debt to increase returns. Double and triple-leveraged ETFs can lose more than double or triple the value of the tracked stock; and
- ***ETFs Possess a Shutdown Risk*** – There is a minor risk that an ETF will close. Investors would get their money back, but then they would have to reinvest the money. Investors may not be prepared to pay capital gains taxes and other fees.

Conclusion – Essay on Mutual Funds and Exchange Traded Funds

In conclusion, based on the analysis above, it is evident that mutual funds and ETFs share some similarities and differences. Both have annual expense fees, are managed by financial professionals, and can be part of employee retirement plans, such as a 401K or an IRA. However, they are treated differently by the SEA34 and the SEC, have different commission structures, and are bought and sold at different times during a trading day and through different organizations. Finally, the amount of capital gains taxes paid depends on whether the taxes only consider the gains or the gains and losses. Also, the advantages and disadvantages of ETFs can be significant. Thus, when deciding whether to invest in a mutual fund or an ETF, an investor should ensure that the type of investment selected satisfies both their short-term objectives and long-term goals. Only then can the proper decision be made.

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[127] Troy Segal, Advantages and Disadvantages of ETFs, *Investopedia* (May 24, 2024), *available at* https://www.investopedia.com/articles/exchangetradedfunds/11/advantages-disadvantages-etfs.asp.
[128] *Id.*

ESSAY ON HEDGE FUNDS AND PRIVATE EQUITY FUNDS

In this essay, the role of general and limited partners are discussed in the context of hedge funds and private equity funds. First, hedge funds are defined and their types and characteristics are outlined. Second, private equity funds are defined and their specialties and characteristics are highlighted. Third, general partners and limited partners are defined. Fourth, the role of general and limited partners in a hedge fund are examined. Fifth, the role of general and limited partners in a private equity fund are considered. Sixth, the regulatory concerns of hedge funds and private equity funds are reviewed. Finally, the essay concludes that the decision of whether to invest in a hedge fund or a private equity fund depends on investor characteristics, such as net worth or the ability to tolerate high risk. Although there are similarities between hedge funds and private equity funds, there are also distinct differences that should be taken into consideration when deciding what instrument to employ.

Hedge Funds

In this section, a hedge fund is defined, the types of hedge funds are outlined, and the characteristics of hedge funds are described.

Definition of a Hedge Fund

Investopedia defines a hedge fund as a "limited partnership of private investors whose money is pooled and managed by professional fund managers."[129] Hedge fund managers employ a diverse set of strategies, including borrowing money and trading non-traditional assets, to earn greater than average returns.[130] Hedge funds are considered high-risk investments that demand a minimum investment or net worth.[131] According to the SEC, hedge funds "pool investors' money and invest the money to make a positive return."[132] Hedge funds are typically more flexible than mutual funds because they attempt to profit in different markets via leverage (borrowing money), selling short, and employing other speculative strategies.[133]

Types and Characteristics of Hedge Funds

The four common types of hedge funds include:[134]

- ***Global macro hedge funds:*** These are actively managed hedge funds that try to profit from large market swings that are the result of political or economic events;
- ***Equity hedge funds:*** These hedge funds invest in lucrative investments while hedging against downturns by shorting overvalued stocks or stock indices;
- ***Relative value hedge funds:*** These hedge funds exploit transitory price differences of related securities, utilizing price or spread inefficiencies.
- ***Activist hedge funds:*** These hedge funds invest in businesses and demand that firms cut costs, restructure assets, or change the board of directors.

As of February 2025, the more noteworthy hedge funds, based on assets under management (AUM) include Bridgewater Associates ($124 billion AUM), Renaissance Technologies ($106 billion AUM), and AQR Capital Management ($94.5 billion AUM).[135] The critical characteristics of hedge funds are:[136]

- Actively traded securities that are focused on alternative investments or risky investment strategies;
- Accredited investors with significant investment or net worth;
- Charge higher fees than traditional investment funds; and
- Investments are usually unavailable for a year before they may be sold or withdrawn.

Private Equity Funds

This section defines a private equity fund, lists the types of private equity funds, and discusses their characteristics.

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[129] Investopedia Team, Hedge Fund: Definition, Examples, Types, and Strategies, *Investopedia* (Apr. 12, 2024), *available at* https://www.investopedia.com/terms/h/hedgefund.asp.
[130] *Id.*
[131] *Id.*
[132] SEC Staff, Hedge Funds, *U.S. Securities and Exchange Commission: Office of Investor Education and Advocacy* (Feb. 2013), *available at* https://www.sec.gov/files/ib_hedgefunds.pdf.
[133] *Id.*
[134] Investopedia Team, *supra*, note 129.
[135] Rebecca Baldridge, Top 10 U.S. Hedge Funds of February 2025, *Forbes* (Nov. 1, 2024), *available at* https://www.forbes.com/advisor/investing/top-hedge-funds/.
[136] Investopedia Team, *supra*, note 129.

Definition of a Private Equity Fund

According to Chen, private equity funds are "investment partnerships that buy and manage companies before selling them."[137] Private equity funds invest on behalf of institutional and accredited investors (individuals with high net worth) so that the invested organization becomes a private entity, no longer listed on a stock exchange.[138] Private equity funds are like venture capital and hedge funds where investment monies are typically locked up for years.[139] According to the SEC, a private equity fund is a "pooled investment vehicle where the adviser pools together the money invested in the fund by all the investors and uses that money to make investments on behalf of the fund,"[140] much like a mutual fund or a hedge fund. However, in contrast to mutual funds or hedge funds, private equity firms typically concentrate on long-term investment opportunities in assets with a time horizon typically of 10 or more years.[141]

Specialties and Characteristics of Private Equity Funds

Private equity funds sometimes specialize in particular types of deals, including venture capital deals. Additional specialties include:[142]

- ***Distressed investing:*** Specializing in struggling companies with critical financing needs;
- ***Growth equity***: Funding expanding companies beyond their startup phase;
- ***Sector specialists***: Focusing solely on technology or energy deals;
- ***Secondary buyouts***: Purchasing a company owned by one private equity firm to another such firm;
- ***Carve-outs***: Buying corporate subsidiaries or units.

Examples of a carve-out include Carlyle's purchase of Tyco Fire & Security Services Korea Co. Ltd. from Tyco International Ltd. in 2014, and Francisco Partners' deal to obtain the corporate training platform Litmos from German software giant SAP SE in August 2022.[143]

The four typical characteristics of private equity funds are:[144]

- Buying companies and overhauling them to earn a profit when the business is sold again;
- Capital for the acquisitions originates from outside investors and is usually supplemented by debt;
- The private equity industry has grown rapidly, particularly when stock prices are high, and interest rates are low; and
- An acquisition by a private equity fund can make a company more competitive or saddle it with unsustainable debt, depending on the objectives of the private equity fund.

General Partners and Limited Partners

In this section, a general partner and a limited partner are defined. Each one is defined one after the other.

Definition of a General Partner

According to Kenton, a general partner is a "part-owner of a partnership business and is involved with its operations and shares in its profits."[145] A general partner can act on behalf of the business without informing the other partners. In contrast to a silent partner, a general partner may experience unlimited liability for business debts. General partners typically contribute clients and contacts, bringing specialized knowledge and skills to a partnership. They also share management responsibilities with other general partners.[146]

The primary benefit of a partnership is that the partners, rather than the partnership, are taxed. Partnerships do not pay corporate taxes on profits because partners are taxed individually on their profits. This means that a general partner may be personally responsible for partnership liabilities.[147] For example, a patient may sue all the general partners in some states in a medical

[137] James Chen, Private Equity Explained with Examples and Ways to Invest, *Investopedia* (Apr. 10, 2024), *available at* https://www.investopedia.com/terms/p/privateequity.asp.
[138] *Id.*
[139] *Id.*
[140] SEC Staff, Private Equity Funds, *U.S. Securities and Exchange Commission* (n.d.), *available at* https://www.investor.gov/introduction-investing/investing-basics/investment-products/private-investment-funds/private-equity.
[141] *Id.*
[142] *Id.*
[143] *Id.*
[144] *Id.*
[145] Will Kenton, General Partner: Definition, Role, Examples, and Main Benefits, *Investopedia* (Aug. 26, 2021), *available at* https://www.investopedia.com/terms/g/generalpartner.asp.
[146] *Id.*
[147] *Id.*

malpractice case. If a court rules in favor of the patient, all the partners would be financially responsible, and their assets would be subject to liquidation.[148]

Definition of a Limited Partner

Again, according to Kenton, a limited partner, also known as a silent partner, "invests money in exchange for shares in a partnership but has restricted voting power on company business and no day-to-day involvement in the business."[149] A limited partner does not possess the full voting power of a general partner. The income provided to a limited partner is considered by the Internal Revenue Service (IRS) as passive income. However, if a limited partner participates in the management of the partnership for more than 500 hours in a year, they are considered a general partner. Some states permit limited partners to vote on the structure of the partnership, such as removing general partners, terminating the partnership, revising the partnership agreement, or selling the partnership's assets.[150]

A limited partner purchases shares in the partnership for investment purposes but is not involved in daily operations.[151] Limited partners cannot incur obligations on behalf of the partnership. This means that limited partners are not personally liable for partnership debts. A limited partner may be personally liable if they take on active duties within the partnership. Finally, a limited partner's liabilities cannot be greater than their investment in the partnership.[152]

Role of a General Partner and Limited Partner in a Hedge Fund

Hedge funds are typically structured as limited partnerships. The fund manager is the general partner and the investors are limited partners. The general partner is responsible for investing the monies from the limited partners and managing the investment portfolio.[153] Because hedge funds must be registered under ICA40, an investor must be accredited, where the minimum investment is usually $1 million.[154] Investors can directly invest in a hedge fund. Investors can also access a hedge fund through a feeder fund, an investment vehicle where a fee is paid for access with a much smaller minimum investment. For feeder funds, the minimum investment can be as low as $100,000.[155] With a feeder fund, an investor has access through the feeder funds to hedge fund documents that can be used to assess the qualifications of the fund manager and the fund's investment strategy.

Many hedge funds charge annual management fees between one and two percent of the fund's NAV, which are used to pay general business expenses and overhead costs, such as computers, employee salaries, and other business management expenses.[156] General Managers also charge performance fees of approximately 10 to 20 percent of annual aggregate profits. This fee structure is an incentive for general managers to ensure a fund's strong economic performance.[157] Some hedge funds have high water marks when calculating performance fees. In other words, performance fees can only be charged when returns are above a previous high value, thus ensuring that performance fees are only charged on new profits.[158] Some hedge funds have hurdle rates or a minimum annual return limited partners are entitled to before a general partner can receive a performance fee.[159] Sometimes, hedge funds have both a high-water mark and a hurdle rate. Hedge fund operating expenses are generally between 15 to 30 basis points of the fund's AUM and are charged annually. Additionally, hedge funds may charge pass-through fees that cover payouts to multiple portfolio management teams that make investments on behalf of the fund.[160]

Role of a General Partner and Limited Partner in a Private Equity Fund

Like a hedge fund, in a private equity fund, a general partner is accountable for managing the fund, making investment decisions, and supervising fund operations. Also, a limited partner in a private equity fund is limited in their management responsibilities, acting as a passive investor with their liability constrained by their investment amount.[161] According to the SEC,

[148] *Id.*
[149] Will Kenton, Limited Partner: What It Is, Laws, Role, and Tax Treatment, *Investopedia* (Oct. 2, 2022), *available at* https://www.investopedia.com/terms/l/limited-partner.asp.
[150] *Id.*
[151] *Id.*
[152] *Id.*
[153] Joseph Burns, Understanding How Hedge Funds Work, *iCapital* (n.d.), *available at* https://icapital.com/insights/hedge-funds/understanding-how-hedge-funds-work/.
[154] *Id.*
[155] *Id.*
[156] *Id.*
[157] *Id.*
[158] *Id.*
[159] *Id.*
[160] *Id.*
[161] James Chen, *supra*, note 137.

private equity funds are not required to be registered or regulated as investment companies under federal securities laws.[162] The reason is that a private equity fund cannot publicly offer its securities. Investors can access a private equity fund via feeder funds.[163] A general partner typically contributes one to three percent of a private equity fund's initial capital to ensure the individual has a vested interest in the fund's success. This is known as having skin in the game.[164] The general partner also earns a management fee, which may be established as two percent of fund assets, and may be eligible for 20 percent of the fund's profits above a prescribed minimum known as carried interest.[165] Finally, private equity funds can institute hurdle rates and pass-through fees like hedge funds.[166]

Regulatory Structure for Hedge Funds and Private Equity Funds

This section describes the regulatory structure for hedge funds and private equity funds and discusses each one in turn.

Regulatory Structure and Hedge Funds

Hedge funds are subject to the SEC under the Investment Advisers Act (IAA40) of 1940 and the CFTC under the Commodity Exchange Act (CEA36) of 1936.[167] Hedge funds are also under the domain of other federal and state laws, including self-regulatory organizations such as FINRA.[168] Hedge funds with $50 million or more in AUM must register with the SEC under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) of 2010.[169] Registered advisers must file Form ADV, revealing information about their business, ownership, clients, employees, business practices, and disciplinary events. Some hedge funds must file Form PF with the SEC, by supplying information about the hedge funds they counsel, including size, leverage, performance, and types of investors so that the SEC can manage systematic risk.[170]

The Jumpstart Our Business Startups Act (JOBS) of 2012 altered hedge fund marketing and solicitation rules. Previously, hedge funds could not generally solicit under Regulation D or Rule 506 of SA33. Title II of JOBS created Rule 506(c) that permitted general solicitation as long as all the investors were accredited and the fund made reasonable efforts to ensure their investors were accredited.[171] Hedge funds must provide prospective investors with a private placement memorandum (PPM) that discloses the fund's strategy, principal risks, potential conflicts of interest, and fund management.[172]

Regulatory Structure and Private Equity Funds

Like hedge funds, private equity funds transactions are regulated by the SEC and FINRA. The critical regulatory requirements for private equity funds are:[173]

- ***Registration and reporting requirements:*** Private equity funds must register with the SEC under the IAA and include information regarding the fund's size, governance, risk factors, and potential conflicts of interest to ensure transparency;
- ***Investor qualifications:*** Private equity funds are usually available to institutional investors and accredited individual investors, entities that can bear the high risk and the lack of liquidity;
- ***Disclosure requirements:*** Private equity funds must provide detailed information to their investors, including financial statements, valuation procedures, investment strategy and objections, and management personnel; and
- ***Corporate governance and fiduciary duties:*** Private equity funds are legally required to act in the best interest of their clients by being fair and transparent.

Differences in Regulatory Requirements

The differences in regulatory requirements between hedge funds and private equity funds are:[174]

[162] SEC Staff, Private Funds, *U.S. Securities and Exchange Commission* (Sep. 19, 2024), *available at* https://www.sec.gov/resources-small-businesses/capital-raising-building-blocks/private-funds.
[163] Asset Tribe Staff, All You Need to Know About Feeder Funds, *Asset Tribe* (n.d.), *available at* https://assettribe.io/all-you-need-to-know-about-feeder-funds/.
[164] James Chen, *supra*, note 137.
[165] *Id.*
[166] Barry Steinman, Private Equity Fund Fees, *Duane Morris* (Aug. 2014), *available at* Regulaturyhttps://www.duanemorris.com/site/static/private_equity_fund_fees.pdf.
[167] Sergei Tokmakov, Understanding Regulatory Requirements: Hedge Funds vs Private Equity, *Terms.law* (n.d.), *available at* https://terms.law/2023/07/26/understanding-regulatory-requirements-hedge-funds-vs-private-equity/#:~:text=B.-,Regulatory%20Bodies%20Overseeing%20Hedge%20Funds,under%20the%20Commodity%20Exchange%20Act.
[168] *Id.*
[169] *Id.*
[170] *Id.*
[171] *Id.*
[172] *Id.*
[173] *Id.*
[174] *Id.*

- ***Differences in investor qualifications:*** Private equity funds typically require accredited or qualified purchasers, whereas hedge funds can accept non-accredited purchasers provided they satisfy specific wealth or income thresholds. As specified by the ICA, there can be no more than 100 non-accredited investors. This means that both hedge and private equity funds are not generally available to retail investors.
- ***Differences in transparency and disclosure requirements:*** Hedge and private equity funds have different disclosure requirements. Hedge funds must disclose specific information in Form ADV, whereas private equity funds do not have to give the same degree of information. Private equity funds may supply such information via a PPM. In general, private equity funds are less transparent than hedge funds.
- ***Differences in marketing and solicitation rules:*** Hedge and private equity funds have different marketing and solicitation rules. Hedge funds have more marketing flexibility, while private equity funds have more rigid marketing rules.

Conclusion – Essay on Hedge Funds and Private Equity Funds

In conclusion, although there are many similarities between hedge funds and private equity funds, there are also substantial differences. Whether to invest in a hedge fund or a private equity fund depends on the financial characteristics of an investor. If one prefers investment flexibility, then a hedge fund may be an ideal vehicle, whereas if one is content with a restricted financial environment, a private equity fund may be the preferred financial instrument. As always, the choice is subject to investor preferences.

ESSAY ON SECURITIZATION

This essay discusses the advantages and disadvantages of securitization, arguing that the advantages to the issuer and the investor outweigh the disadvantages based on the information provided herein. First, piece defines securitization. Second, how securitization works is outlined, where the different types are listed. Third, the steps in securitization are enumerated. Fourth, the advantages and disadvantages of securitization are described, where the advantages and disadvantages are divided by issuer and investor. Finally, the essay concludes by noting that securitization is an outgrowth of compound interest and its ever-increasing complexity. The paper laments that removing interest or severely limiting it short of a catastrophic financial event is unlikely.

Definition of Securitization

According to Chen, securitization is “the financial alchemy of taking not-easily- or nontradable assets, pooling them together, and selling tradeable shares in that pool to investors.”[175] Essentially, securitization takes any assets, combines them, and then sells the related security.[176] According to Bondarenko, securitization is “the practice of pooling together various types of debt instruments (assets) such as mortgages and other consumer loans and selling them as bonds to investors.”[177] A bond created this way is generally known as an asset-backed security (ABS) or collateralized debt obligation (CDO).[178] If the debt pool consists of mortgages, the resulting bond is called a mortgage-backed security (MBS).[179] Investors who hold the bond are entitled to the principal and interest payments on the underlying assets.[180]

How Securitization Works

With securitization, the institution or individual, known as the originator, that holds the basket of assets decides which assets to remove from its balance sheet, usually because it no longer desires to service or raise capital for more loans.[181] The collection of assets is then thought of as a reference portfolio. The originator proceeds to sell the portfolio to an issuer who has a stake in the asset portfolio. Investors then purchase the securities in exchange for a specific rate of return.[182]

Securitization aims to remove assets from its balance sheet to underwrite new loans.[183] Investors profit because they earn a rate of return predicated on the associated principal and interest payments on the underlying assets paid to the originator by the owners of the specific assets.[184] The general types of securitization include pass-through securitization, pay-through debt instruments, and CDOs.[185] With pass-through securitization, money flows from the underlying asset pool to investors holding the

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[175] James Chen, Securitization: Definition, Pros & Cons, Example, *Investopedia* (Jun. 14, 2024), *available at* https://www.investopedia.com/terms/s/securitization.asp.
[176] *Id.*
[177] Peter Bondarenko, Securitization, *Encyclopedia Britannica: Britannica Money* (Jan. 15, 2025), *available at* https://www.britannica.com/money/securitization.
[178] *Id.*
[179] *Id.*
[180] *Id.*
[181] James Chen, *supra*, note 137.
[182] *Id.*
[183] *Id.*
[184] *Id.*
[185] *Id.*

associated bond. The issuer creates pass-through or flow-through certificates that signify an undivided interest in the asset pool. As borrowers make payments, the loan servicer collects and proportionally distributes them.[186] MBS that Fannie Mae and Freddie Mac issue exemplify pass-through securitization.[187]

For pay-through debt instruments, collateralized mortgage obligations (CMOs) or real estate mortgage investment conduits, money moves from the underlying asset pool to pay interest and principal while the underlying assets are structured as debt obligations.[188] The securities are grouped by different maturities, risk profiles, and payment profiles, where the groupings are called tranches. The cash flows are allocated according to a pre-specified structure, where senior tranches receive payments before junior tranches.[189]

Collateralized debt obligations (CDOs) involve collecting diverse debt obligations, like corporate bonds, loans, or even other securitized products like MBS or ABS, pooling the assets, and then dividing them into tranches where each tranche possesses separate risk and return characteristics.[190] To complicate matters, CDO-squared and CDO-cubed securities have assets consisting of CDOs and CDOs-squared, respectively. The complexity and lack of transparency make it difficult to understand or estimate the risks involved. These securities played a major role in the 2007 and 2008 financial crises.[191] One can only wonder what the economic effect would be if interest or usury were severely limited or outlawed entirely, as it was in Europe by the Roman Catholic Church during the Middle Ages.[192] Securitization would be non-existent, and the risk, if any, would be elementary to determine. In greater detail, the different types of securitization are contained in the table below.

Steps in Securitization

Securitization is a complex process that involves the following ten steps:[193]

1. ***Asset origination:*** A lender, like an investment bank, issues loans to borrowers such as business lines of credit, mortgages, auto loans, credit card receivables, etc.
2. ***Create asset pools:*** The lender selects loans with similar features, such as loan type, maturity, and credit quality, where the collection loans will act as collateral for issuing securities.
3. ***Create the special purpose vehicle (SPV):*** The lender creates a separate legal special purpose vehicle (SPV). If the lender goes bankrupt, the SPV's assets are unaffected.
4. ***Transfer the assets:*** The lender sells the loans to the SPV, removing the assets from its balance sheet. The SPV pays the lender for the assets using monies raised from issuing securities.
5. ***Tranching:*** The SPV categorizes the pool of loans into different risk classes, known as tranches. Each tranche has a different level of risk and return. The tranches are classified as senior, mezzanine, and junior (or equity).
6. ***Credit enhancement:*** The SPV sometimes uses credit enhancement techniques to make the securities more attractive. These may include over-collateralization (i.e., putting more collateral in the pool than the value of the securities issued), reserve accounts, or third-party guarantees.
7. ***Rating:*** The SPV then engages credit rating agencies to assess the creditworthiness of each tranche. The rating agencies allocate ratings to the tranches based on their perceived risk. The senior tranches receive the highest ratings, while the junior tranches receive the lowest.
8. ***Marketing and sale:*** The securities are marketed and sold to investors via investment banks. Investors can invest in different tranches based on their risk preferences.
9. ***Distribute cash flows:*** As the underlying loan borrowers make payments, the servicer collects the cash and distributes it to the investors. Regarding payment, the senior tranches have priority over the junior tranches.
10. ***Monitoring and reporting:*** Throughout the life of the securities, the servicer monitors the performance of the underlying loans and provides regular reports to the investors.

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[186] *Id.*
[187] SEC Staff, Mortgage-Backed Securities and Collateralized Mortgage Obligations, *U.S. Securities and Exchange Commission* (n.d.), *available at* https://www.investor.gov/introduction-investing/investing-basics/glossary/mortgage-backed-securities-and-collateralized.
[188] James Chen, *supra*, note 137.
[189] *Id.*
[190] *Id.*
[191] Id.
[192] Nathan Dorn, The Consilia of Alessandro Nievo: On Jews and Usury in 15th Century Italy, *Library of Congress Blogs* (May 20, 2016), *available at* https://blogs.loc.gov/law/2016/05/the-consilia-of-alessandro-nievo-on-jews-and-usury-in-15th-century-italy/.
[193] James Chen, *supra*, note 175.

Securitized Products	Underlying Assets	Description	Risk
Asset-Backed Securities	Auto loans, credit card debt, student loans, etc.	Diversified asset pool, where loan payments are passed through to investors	Risk depends on the underlying assets and the structure of the ABS bond
Collateral Bond Obligations	Corporate bonds	Similar to CDOs, but backed by corporate bonds	Risk is generally higher than MBS
Collateralized Debt Obligations	Bonds, loans, MBS, ABS, etc.	Complex securities with multiple tranches that give different risk returns	High risk due to complexity and leverage
CDO-Squared	Tranches of other CDO securities	Highly complex and leveraged	Extremely high risk
CDO-Cubed	Tranches of CDO-squared securities	Highly complex and leveraged	Extremely high risk
Collateralized Loan Obligations	Leverage bank loans	Similar to CDOs, but backed by leveraged loans	High risk because the bank loans are leveraged
Commercial Mortgage-Backed Securities	Commercial mortgage loans	Backed by commercial properties that produce income	Risk is typically higher than RMBS
Mortgage-Backed Securities	Residential or commercial mortgage loans, including U.S. government or private MBS	Pooled mortgages where principal and interest payments are passed through to investors	Risk depends on underlying the structure of the security and whether the bonds are backed by the federal government
Residential Mortgage-Backed Securities	Residential mortgage loans	Backed by loans on single-family dwellings, including condominiums	Risk depends on the underlying mortgages and the issuer

Advantages and Disadvantages of Securitization

In this section, the advantages and the disadvantages to the issuer and investors are listed.

Advantages and Disadvantages to the Issuer

The advantages to the issuer of securitization include:[194]

- Reduces funding cost;
- Reduces asset-liability mismatch;
- Lowers capital requirements;
- Locks in profits;
- Lowers transfer risks;
- Off-balance sheet items have no balance sheet effect;
- Earnings bounces can be recorded with no addition to the firm;
- Turns an admissible future surplus flow into an admissible immediate cash asset; and
- Cash flows from off-balance sheet items may be available for immediate spending.

The disadvantages to the issuer of securitization are:[195]

- May reduce portfolio quality;
- May be expensive due to management and system costs, legal fees, underwriting fees, rating fees, and ongoing administration;
- Often demands large-scale structuring that may not be cost-efficient for small and medium transactions; and
- May include par structures and credit enhancements that can involve risks of impairment, such as prepayment risk and credit loss risk.

[194] Wikipedia Staff, Securitization, *Wikipedia.org* (Jan. 30, 2025), *available at* https://en.wikipedia.org/wiki/Securitization.
[195] *Id.*

Advantages and Disadvantages to Investors

The advantages to investors due to securitization include:[196]

- Opportunity to earn a high rate of return on a risk-adjusted basis;
- Encourages portfolio diversification, particularly for hedge funds; and
- Isolation of the credit risk from the parent entity.

The disadvantages or risks to investors because of securitization are:[197]

- Potential credit/default risk;
- Prepayment/reinvestment/early amortization risk;
- Currency interest rate fluctuations risk;
- Potential for a moral hazard by marking up the prices of the portfolio assets; and
- Potential for a servicer risk if the transfer or collection of payments may be delayed or reduced if the servicer becomes insolvent.

Comparison of Advantages and Disadvantages

This section compares the advantages and disadvantages to the issuer and the investor, where each comparison occurs.

Issuer Comparison

The significant advantage to the issuer is that securitization reduces the risk of loss. The idea behind securitization is that for a large pool of assets, if any particular asset is exposed to significant risk, the risk effect on the pool is negligible. Only if a significant number of the underlying assets experience such high risk would the risk to the securitized bond be affected. Another issue is that the issuer has low capital requirements with securitization, meaning they need not retain an inordinate amount of reserves. This fact permits the issuer to attract more business, which is securitized. Also, what happens if the underlying loan goes into default? When a loan is securitized, the paperwork showing that the issuer owns the loan may be destroyed, ensuring that the issuer cannot foreclose on the property. The borrower may ask the issuer or originator to prove they own the loan. Without the paperwork, the court may not allow the issuer or originator to foreclose on the loan, and take possession of the asset.

Investor Comparison

When looking at the advantages and disadvantages to investors, the opportunities to earn a high rate of return and portfolio diversification are attractive provided that the associated risks are knowable and measurable. The problem with securitization is that the complexity of the bond may ensure that the risk is difficult to calculate. If the securitized bond is a CDO-squared or a CDO-cubed, the risk may be unknowable because of the difficulty in calculating it. This is an issue because if the risk cannot be reasonably measured, then the investor can assume that the risk is one thing, whereas in reality, it is quite different.

Conclusion – Essay on Securitization

In conclusion, the Roman Catholic Church forbade Christians from charging interest or usury during the Middle Ages.[198] The introduction of compound interest was one of the reasons for the Renaissance and the Industrial Revolution in the 19th Century. However, one can gain financial benefits without manual labor if one is on the right side of compound interest. The reason is because investors are taking value from the borrower of the underlying asset. In other words, based on the analysis above, interest and profit are goals in and of themselves.

If one is on the wrong side of interest or usury, one works untold hours to pay off the loan, possibly never paying it off. If there is a benefit, the borrower has exclusive use of the asset as long as they make the principal and interest payments. If they default for some reason, they lose the exclusive right to use the asset and forfeit their hours, days, months, and even years of labor.

If interest were deemed to be illegal, what would be the effect? First, securitization would not exist. Second, individual borrowers would pay only for the price of the asset. This would dramatically reduce the time and the amount of money the borrower would pay. Will this ever happen? Most likely not, unless there was a significant financial crash of momentous proportions. The likelihood of this happening in the foreseeable future is slim to none.

ESSAY ON FUTURES/FORWARD CONTRACTS AND OPTIONS CONTRACTS

This essay discusses futures/forward contracts and options contracts. First, a futures contract followed by a forward contract is defined, followed by a brief description of their characteristics. Second, an options contract is defined, followed by an explanation of puts and calls. Third, the benefits of futures and forward contracts are highlighted, followed by an overview of the benefits of an options contract. Finally, the piece ends by summarizing the information contained herein.

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[196] *Id.*
[197] *Id.*
[198] Nathan Dorn, *supra*, note 193.

Definition of a Future/Forward Contract

According to Phung, forward and futures contracts are "derivatives that involve two parties who agree to buy or sell a specific asset at a set price by a certain date in the future."[199] A determining feature of a future/forward contract is that buyers and sellers may mitigate the risks of changing prices by locking them in advance.[200] A forward contract is made over the counter (OTC) and settles at the end of the contract. The two parties negotiate the terms of the contract. A forward contract possesses a default risk because the other party may not be able to deliver the goods or make the payment.[201] A forward contract is made OTC and settles just once—at the end of the contract. Both parties privately negotiate the contract's exact terms. Forwards carry a default risk since the other party might not come up with the goods or the payment. In contrast, futures contracts may be traded on a stock exchange and settle daily. Futures contracts have fixed maturity dates and uniform terms. They have counterparty risk because they guarantee payment on a specific date.[202]

One difference between a forward contract and a futures contract is that forward contracts are traded over the counter, while futures contracts are traded on listed exchanges.[203] Also, the terms of a forward contract can be customized, whereas the terms of a futures contract are standardized. Third, with forward contracts, there are no upfront costs, while with futures contracts, futures contracts must be paid with an initial margin. Finally, the counterparty risk for a forward contract is high, whereas the counterparty risk for a futures contract is low.[204] In tabular form, this looks like:

Characteristics	**Forward Contracts**	**Futures Contracts**
Traded	Over the Counter	On Listed Exchanges
Terms	Customizable	Standard
Cost	None Upfront	Must Be Paid with Initial Margin
Counterparty Risk	Higher	Very Low

Definition of an Options Contract

According to Hargrave, an options contract is a "financial agreement that grants the buyer the right, but not the obligation, to buy or sell a particular asset (like a stock) at a preset price within a given period."[205] With the increasing complexity of financial markets, options have been transformed from a esoteric tool to a mainstream vehicle due to their ability to leverage gain, manage risk, and strategic flexibility.[206] Individual and large institutional investors employ options for speculation, hedging, and generating income. In the past 10 years, options have increased approximately 150 percent and 15-fold since 2000.[207] During the pandemic, about 50 percent of the trading volume was in options, and the current trading volume is in the low 40 percent range.[208]

The two types of options contracts are puts and calls. Both options can be purchased to speculate and possibly profit from price changes or hedge exposure in positions an investor already has. They can also be sold and generate income. Call options may be purchased as a leveraged bet that the price of a stock increases, whereas put options are bought to profit from stock price decreases.[209] The purchaser of a call option has the right but not the obligation to buy the shares at the strike price covered in the option. The purchaser of a put option has the right but not the obligation to buy the shares at the strike price specified in the contract.[210] In both cases, the option sellers must perform their side of the trade if the buyer decides to execute their option.[211]

In a call option transaction, the seller is paid a premium to sell the shares at the strike price. When the seller retains the shares to be sold, the position is known as a covered call.[212] In a put option contract, if the share price drops below the strike price before or when the contract expires, the buyer can sell the shares to the option seller at the strike price or sell the contract when the shares are not in the buyer's portfolio. Traders typically buy calls when the market moves upward because the stock price will

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[199] Albert Phung, Forward Contracts vs. Futures Contracts: What's the Difference?, *Investopedia* (Oct. 245, 2024), *available at* https://www.investopedia.com/ask/answers/06/forwardsandfutures.asp.
[200] *Id.*
[201] *Id.*
[202] *Id.*
[203] *Id.*
[204] *Id.*
[205] Marshall Hargrave, Options Contract: What It Is, How It Works, Types of Contracts, *Investopedia* (Jun.17, 2024), available at https://www.investopedia.com/terms/o/optionscontract.asp.
[206] *Id.*
[207] *Id.*
[208] *Id.*
[209] *Id.*
[210] *Id.*
[211] *Id.*
[212] *Id.*

probably appreciate.[213] On the other hand, when the market is travelling downward, traders usually purchase puts. In market downturns, traders sell calls, while in market upswings, traders sell puts.[214]

Benefits of a Future/Forward Contract for Businesses Alpha and Beta

This section is divided into two subsections. A futures contract is examined in the first subsection, while a forward contract is discussed in the second example.

Futures Contract Example

Suppose Business Alpha is an oil producer and desires to lock in a price where the company will deliver at a future date. If Business Alpha is concerned that the oil demand will decline, which will affect the market oil price and the firm's retained earnings, Business Alpha enters into a futures contract to lock in the price at $75 per barrel, while anticipating that the price will drop in six months. If demand decreases to $65 per barrel, Business Alpha can settle the contract at $75, making a $10 per barrel profit. On the other hand, if the price per barrel increases to $85 per barrel, Business Alpha loses the $10 per barrel profit, even though the firm remains protected if the price drops below $75 per barrel.[215]

Forward Contract Example

Suppose Business Beta is a soybean producer and believes that the price of soybeans will drop soon. Hedging the risk, Business Beta contracts with a financial institution to sell 3 million bushels for $6.50 per bushel in six months. The contract is to be settled in cash. The possibilities are:[216]

- The future price is exactly what was contracted. The contract is settled per the agreement, and neither party owes the other party any money.
- The price is lower than the negotiated price. If the price declines to $5 per bushel, but the transaction goes through at the $6.50 price per bushel, Business Beta's bet to hedge the risk was successful.
- If the price exceeds $6.50 per bushel, the contract settles at the negotiated price, even though the firm profited from the price increase.

Benefits of an Options Contract for Business Gamma

Options are an effective tool because they permit investors to protect their investments against downside risk while preserving the possibility of an upside gain. The idea behind using an option is taking an offsetting position in a similar security by purchasing a call or put option. Suppose Business Gamma manages an equity portfolio, and the firm wants to protect the portfolio from a possible downturn. The company will likely put options on the stocks in the portfolio. If stock prices decline, the put option increases in value, offsetting the losses in the portfolio.[217]

Options are usually employed for speculative purposes because they leverage prices. The advantage of an option is that one can control a large volume of stock or some other underlying asset for a low premium price. If Business Gamma expects a company's stock price to increase, the firm can purchase a call option. If the stock price increases above the strike price, a profit will be made that is a multiple of the option price. On the other hand, if Business Gamma thinks a stock price will drop, the firm may buy a put option and make money that way.[218]

Suppose Company Delta's stock trades at $100 per share, and Business Gamma buys 100 shares for a total of $10,000. If the cost of an option is $2 per share, the total cost of the option is $200. Assume that the option contract is in force for one month. At the end of the month, if the Company Delta's stock price is at $120 per share, Business Gamma would profit by $2,000 less fees and taxes. If the option price rose to $30 per share, at 100 shares the option contract would be worth $3,000 minus the $200 that one paid for the option, or $2,800. This explanation demonstrates the profit potential for using options contracts even though options contracts are subject to an increased risk of loss.[219]

Conclusion – Essay on Futures/Forward Contracts and Options Contracts

In conclusion, the essay defined futures/forward contracts, and options contracts. It discussed the characteristics of these types of contracts, observing that forward contracts are traded over the counter, are customizable, cost nothing up front, and have high counterparty risk. Futures contracts are traded on listed exchanges, the terms are standard, are paid with an initial margin, and the counterparty risk is low. In contrast, an options contract is a financial agreement that gives the buyer the right, but not the obligation, to buy or sell a given asset. The two types of options contrast are puts and calls. Both are used to evaluate hedge exposure

[213] *Id.*
[214] *Id.*
[215] Albert Phung, *supra*, note 200.
[216] *Id.*
[217] Marshall Hargrave, *supra*, note 206.
[218] *Id.*
[219] *Id.*

to stock price changes. The examples demonstrate how an investor can employ a futures/forward contract and an options contract. These contracts are used to reduce the risk of loss.

CONCLUSION

This article consists of a series of essays on banking, investment banking, insurance, mutual funds, exchange-traded funds, hedge funds, private equity funds, securitization, futures/ forward contracts, and options contracts. The first essay discussed the banking industry, while the second discussed investment banking. The third essay reviewed insurance and its types. The fourth essay compared and contrasted mutual funds with exchange-traded funds. The fifth essay evaluated hedge funds versus private equity funds. The sixth essay discussed securitization and its many facets. The seventh and final essay assessed the characteristics and benefits of futures/forward and options contracts.

The idea behind this article is to provide a single source of information regarding the various financial institutions and instruments available from the financial sector. By doing so, researchers can obtain a basic foundation of the underpinnings of this very important industry. Individuals who want to learn about financial markets should have a springboard so that they may dive into this field of study with a good knowledge of its characteristics and nuances. Such a resource is needed to thoroughly appreciate financial entities and products, a complicated and sometimes obtuse field. This is the goal of this paper. Hopefully, this purpose was achieved.

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