Question #1 of 73

Question ID: 1573817

In contrast with a typical forward contract, futures contracts have:

A) standardized terms.

B) less liquidity.

C) greater counterparty risk.

Explanation

Futures are forward contracts that trade on exchanges and have standardized terms, in contrast with forward contracts, which are customized instruments. A futures clearinghouse reduces counterparty risk by guaranteeing the performance of buyers and sellers. Futures contracts trade on organized exchanges and are more liquid than forward contracts.

(Module 41.1, LOS 41.c)

Question #2 of 73

Question ID: 1573838

An investor purchases stock on 25% initial margin, posting $10 of the original stock price of $40 as equity. The position has a required maintenance margin of 20%. The investor later sells the stock for $45. Ignoring transaction costs and margin loan interest, which of the following statements is *most accurate*?

A) Leverage ratio is 3:1.

B) Margin call price is $36.

C) Return on investment is 50%.

Explanation

Return on invested equity is ($45 – $40) / $10 = 50%.

The leverage ratio is purchase price / equity = $40 / $10 = 4.

Margin call price is $40 × [(1 – 0.25) / (1 – 0.20)] = $37.50.

(Module 41.2, LOS 41.f)

Question #3 of 73

Question ID: 1573860

Which of the following orders is said to be "behind the market"?

A) Market sell order when the best bid is 38 and the best ask is 39.

B) Limit sell order at 38 when the best ask is 39.

C) Limit buy order at 38 when the best bid is 39.

Explanation

A limit buy order is behind the market if its limit price is below the best bid. A limit sell order is behind the market if its limit price is above the best ask. Market orders are never said to be behind the market.

(Module 41.3, LOS 41.h)

Question #4 of 73

Question ID: 1573818

Shares in a publicly traded company that owns gold mines and mining operations are considered:

A) financial assets.

B) physical assets.

C) real assets.

Explanation

Financial assets, such as shares of stock in a company, are claims against physical or real assets.

(Module 41.1, LOS 41.c)

Question #5 of 73

Question ID: 1573843

Which of the following statements about the maintenance margin requirement is *least* accurate?

A) The Federal Reserve sets the maximum maintenance margin.

B) The purpose of the maintenance margin requirement is to protect the broker in the event of a large stock decline.

C) Generally the maintenance margin requirement is lower than the initial margin requirement.

Explanation

The Federal Reserve sets the minimum maintenance margin and individual investment companies may set higher margins if they wish.

(Module 41.2, LOS 41.f)

Question #6 of 73

Question ID: 1573830

Mark Ritchie purchased, on margin, 200 shares of TMX Corp. stock at a price of $35 per share. The margin requirement was 50%. The stock price has increased to $42 per share. What is Ritchie's return on investment before commissions and interest if he decides to sell his TMX holdings now?

A) 40%.

B) 20%.

C) 10%.

Explanation

200 shares × $35 = $7000 Initial Market Value

$7000 × .50 = $3500 cash payment and $3500 borrowed.

The new market value of the stock after price increase is (200 × $42) = $8400. If Ritchie sold his holdings he would have $4900 ($8400 – $3500) left after the loan was paid. So Ritchie's return on his original $3500 investment is:

$4900/3500 – 1 = 1.4 – 1.0 = 0.40 = 40%.

(Module 41.2, LOS 41.f)

Question #7 of 73

Question ID: 1573826

Which of the following statements about short sales is *least accurate*?

A) Proceeds from short sales cannot be withdrawn from the account.

B) The short seller is required to replace the borrowed securities within six months of a short sale.

C) The short seller must pay the lender of the stock any dividends paid by the company.

Explanation

There is no maximum time for which a security can be borrowed. It must be returned whenever the lender requires it to be.

(Module 41.2, LOS 41.e)

Question #8 of 73

Question ID: 1573809

Which of the following conditions is *most likely* necessary for capital to be allocated to its most valuable uses?

A) Financial markets are frictionless (i.e., free of taxes or transactions costs).

B) Investors are well informed about the risk and return of various investments.

C) There are no barriers to the flow of complete information to the financial markets.

Explanation

Capital will flow to its most valuable uses if markets function well and investors are well informed about the risk and return characteristics of various investments. Allocation of capital to its most valuable uses does not require that all investors have complete information or that financial markets are frictionless.

(Module 41.1, LOS 41.a)

Question #9 of 73

Question ID: 1573877

An objective of financial market regulation is to:

A) ensure that inside information is made public in a timely manner.

B) prevent uninformed investors from participating in financial markets.

C) reduce information gathering costs by requiring common financial reporting standards.

Explanation

One of the objectives of market regulation is to require firms to report their financial performance according to a single set of standards, such as those of the IASB or FASB, thereby reducing market participants' cost of gathering information. Market regulation is not designed to prevent uninformed investors from trading, but to protect unsophisticated investors and thereby preserve trust in the financial markets. An objective of market regulation is to prevent those with non-public information from profiting at the expense of other investors, but not necessarily to make all inside information public.

(Module 41.3, LOS 41.l)

Question #10 of 73

Question ID: 1573836

An investor bought a stock on margin. The margin requirement was 60%, the current price of the stock is $80, and the stock price was $50 one year ago. If margin interest is 5%, how much equity did the investor have in the investment at year-end?

A) 73.8%.

B) 60.6%.

C) 67.7%.

Explanation

Margin debt = 40% × $50 = $20; Interest = $20 × 0.05 = $1.

Equity % = [Value – (margin debt + interest)] / Value

$80 - $21 / $80 = 73.8%

(Module 41.2, LOS 41.f)

Question #11 of 73

Question ID: 1573844

Toby Jensen originally purchased 400 shares of CSC stock on margin at a price of $60 per share. The initial margin requirement is 50% and the maintenance margin is 25%. CSC stock price has fallen dramatically in recent months and it closed today with a sharp decline bringing the closing price to $40 per share. Will Jensen receive a margin call?

A) No, he meets the minimum initial margin requirement.

B) No, he meets the minimum maintenance margin requirement.

C) Yes, he does not meet the minimum maintenance margin requirement.

Explanation

Total original value held by Jensen is 400 × $60 = $24,000.

Amount of equity is 50% ($24,000) = $12,000.

Current total value is 400 × $40 = $16,000.

So Jensen's equity is $16,000 - $12,000 = $4,000 which is 4,000/16,000 = 25% of the total market value.

(Module 41.2, LOS 41.f)

Question #12 of 73

Question ID: 1581357

A trader enters a limit order to buy 10,000 shares as a day order. The "day order" instruction is *most accurately* referred to as:

A) a validity instruction.

B) a clearing instruction.

C) an execution instruction.

Explanation

Validity instructions specify when a trade is to be executed. Specification of a day order (as opposed to a good-til-canceled order) is a validity instruction. (Module 41.3, LOS 41.g)

Question #13 of 73

Question ID: 1573870

Which of the following statements about securities exchanges is *most* accurate?

A) Call markets are markets in which the stock is only traded at specific times.

B) Continuous markets are markets where trades occur 24 hours per day.

C) Setting a negotiated price to clear the market is a method used to set the closing price in major continuous markets.

Explanation

Continuous markets are markets where trades occur at any time the market is open (i.e., they do not need to be open 24 hours per day). Setting one negotiated price is a method used in major continuous markets to set the opening price.

(Module 41.3, LOS 41.j)

Question #14 of 73

Question ID: 1573865

Which of the following statements regarding primary and secondary markets is *least accurate*?

A) New issues of government securities can be sold on the primary market.

B) Prevailing market prices are determined by primary market transactions and are used in pricing new issues.

C) Secondary market transactions occur between two investors and do not involve the firm that originally issued the security.

Explanation

Prevailing market prices are determined by the transactions that take place on the secondary market. This information is used to determine the price of new issues sold on primary markets.

(Module 41.3, LOS 41.i)

Question #15 of 73

Question ID: 1573820

Which of the following statements about financial intermediaries is *most accurate*?

A) Arbitrageurs buy securities with the anticipation that they will be able to sell the securities in the future at higher prices.

B) Brokers seek out traders that are willing to take the opposite sides of their clients' orders.

C) Dealers buy a security in one market and simultaneously sell the same security in a different market.

Explanation

Brokers seek out traders that are willing to take the opposite side of their clients' orders. Arbitrageurs buy an instrument in one market and simultaneously sell the same instrument in a different market at a higher price. Dealers buy securities from clients, with the expectation that they will be able to sell the securities to other clients in the future at higher prices.

(Module 41.1, LOS 41.d)

Question #16 of 73

Question ID: 1573874

A financial system in which transactions have low costs is said to exhibit:

A) allocational efficiency.

B) informational efficiency.

C) operational efficiency.

Explanation

Operational efficiency refers to low transactions costs. A financial system exhibits informational efficiency if prices quickly reflect all information relevant to fundamental value. A market exhibits allocational efficiency if it results in capital being directed to its most productive uses.

(Module 41.3, LOS 41.k)

Question #17 of 73

Question ID: 1573847

An investor purchases 200 shares of Rubble, Inc. on margin. The shares are trading at $40. Initial and maintenance margins are 50% and 25%. If the company pays a dividend of $0.75 and the investor sells the stock at year-end for $50 per share, the return on the investment would be *closest* to:

A) 15.75%.

B) 39.55%.

C) 53.75%.

Explanation

Dividend income = 0.75 × 200 = $150

Profit = 10,000 – 8,000 + 150 = 2,150

Return = 2,150 / 4,000 = 53.75%

(Module 41.2, LOS 41.f)

Question #18 of 73

Question ID: 1573859

A buy limit order is said to be "inside the market" when:

A) the limit is between the best bid and the best ask. ✓

B) the order can be executed. ✗

C) the order is entered in the limit book. ✗

Explanation

A limit order with a limit price between the best bid and the best ask is said to be "inside the market" or "making a new market." A limit order that has not yet been executed is a "standing limit order."

(Module 41.3, LOS 41.h)

Question #19 of 73

Question ID: 1573833

Becky Kirk contacted her broker and placed an order to purchase 1,000 shares of Bricko Corp. stock at a price of $60 per share. Kirk wishes to buy on margin. Assuming the margin requirement is 40%, how much money does Kirk have to pay up front to make the purchase?

A) $60,000. ✗

B) $36,000. ✗

C) $24,000. ✓

Explanation

The margin requirement represents the amount of money an investor must put down on the purchase. So Kirk must put $24,000 down ($60,000 × .40 = $24,000) and can borrow the balance.

(Module 41.2, LOS 41.f)

Question #20 of 73

Question ID: 1573854

Austin Bruno, CFA, places a fill or kill, limit buy order at 92 for a stock. Bruno's order specifies:

A) execution and clearing instructions.

B) validity and execution instructions.

C) clearing and validity instructions.

Explanation

Fill or kill is a validity instruction as it indicates when the order can be filled (i.e. immediately or cancel the order). A limit buy order is an execution instruction as it indicates how the order should be filled (e.g. buy at $92 or less). Clearing instructions indicate how to settle the trade (i.e., how and when to transfer the cash and the security).

(Module 41.3, LOS 41.g)

Question #21 of 73

Question ID: 1573845

Byron Campbell purchased 300 shares of Crescent, Inc., stock at a price of $80 per share. The purchase was made on margin with an initial margin requirement of 50%. Assuming the maintenance margin is 25%, the stock price of Crescent, Inc. has to fall below what level for Campbell to receive a margin call?

A) $20.00.

B) $40.00.

C) $53.33.

Explanation

Trigger price (margin purchases) = P_0 (1 – initial margin) / (1 – maintenance margin).

$80(1 - .5) / (1 - .25) = 40 / .75 = $53.33.

P = $53.33

If Crescent, Inc. falls below $53.33 then Campbell will get a margin call.

(Module 41.2, LOS 41.f)

Question #22 of 73

Question ID: 1573861

A stock's limit order book is as follows:

Bid Size	Limit Price (£)	Offer Size
700	25.25	
300	25.30	
100	25.40	
	25.50	500
	25.55	200
	25.75	500

A new sell limit order is placed for 250 shares at £25.45. This limit order is said to be:

A) an iceberg order.

B) behind the market.

C) making a new market.

Explanation

The order being placed is between the best bid and best ask. It makes a new market with the new bid-ask of £25.40 – £25.45.

(Module 41.3, LOS 41.h)

Question #23 of 73

Question ID: 1573850

A trader pays $100 per share to buy 500 shares of a non-dividend-paying firm. The purchase is done on margin, and the leverage ratio at purchase is 3.0X. Three months later, the trader sells the shares for $90 per share. Ignoring transaction costs and interest paid on the margin loan, the trader's 3-month return was *closest to*:

A) –40%.

B) –10%.

C) –30%.

Explanation

With a leverage ratio of 3 and a 10% decrease in share value, the investor's return is 3 × –10% = –30%.

(Module 41.2, LOS 41.f)

Question #24 of 73

Question ID: 1573829

Lynne Hampton purchased 100 shares of $75 stock on margin. The margin requirement set by the Federal Reserve Board was 40%, but Hampton's brokerage firm requires a total margin of 50%. Currently the stock is selling at $62 per share. What is Hampton's return on investment *before* commission and interest if she sells the stock now?

A) -17%.

B) -35%.

C) -40%.

Explanation

Hampton originally purchased 100 shares at $75 for a total value of $7500. Half of the value ($3750) was borrowed and Hampton paid cash for the other half. The current total market value of the stock is $6200. If Hampton sells her holdings she will have $2450 left after she pays off the loan. Hampton's return on her original investment is:

$2450/3750 – 1 = 0.65 – 1 = -0.35 = -35%.

(Module 41.2, LOS 41.f)

Question #25 of 73

Question ID: 1573848

An investor purchases 100 shares at $75 per share with an initial margin of 50%. Assume there is no interest on the call loan and no transactions fees. If the stock price rises to $112.50, the rate of return to the investor is:

A) 100%.

B) 200%.

C) 50%.

Explanation

$75/share × 100 shares = $7,500.

50% margin means investor only pays half of the $7,500 in cash, or $3,750, and borrows the remaining $3,750.

Rate of return = (market value – initial investment – margin loan repayment) / initial equity

= ($11,250 – $3,750 – $3,750) / $3,750 = 100%.

(Module 41.2, LOS 41.f)

Question #26 of 73

Question ID: 1573840

An investor buys 400 shares of a stock on margin for $25 a share. The initial margin requirement is 50%, and the maintenance margin requirement is 25%. At what price would the investor receive a margin call?

A) $16.67.

B) $21.88.

C) $6.25.

Explanation

Margin call trigger price = $25 × [(1 – 0.5)] / (1 – 0.25)] = $16.67.

(Module 41.2, LOS 41.f)

Question #27 of 73

Question ID: 1573879

Which of the following is *most likely* an objective of market regulation?

A) Limit downside risk to investors.

B) Preserve trust in financial markets.

C) Educate unsophisticated investors.

Explanation

Rules against insider trading and enforcement of laws regarding fraud and theft by corporate managers are intended to preserve trust in the markets of public investors. While clear and honest disclosure and fraud prevention are goals, limiting the downside risk of equities markets is not a likely objective of financial regulation. Neither is the education of unsophisticated investors.

(Module 41.3, LOS 41.l)

Question #28 of 73

Question ID: 1573852

An order placed to protect a short position is called a:

A) protective call.

B) stop loss buy.

C) stop loss sell.

Explanation

A short position profits from declines in stock price and experiences losses as the price rises. A stop loss buy is a limit order that is placed above the market price. When the stock price reaches the stop price, the limit order is executed curtailing further loses.

(Module 41.3, LOS 41.g)

Question #29 of 73

Question ID: 1573868

A trading system that matches buyers and sellers based on price and time precedence is *most likely* a(n):

A) order-driven market.

B) quote-driven market.

C) brokered market.

Explanation

In an order-driven market, buy orders and sell orders are matched up by the exchange according to order matching rules. In a quote-driven market, customers trade with dealers at bid and ask prices set by the dealers. In a brokered market, brokers organize trades among their clients.

(Module 41.3, LOS 41.j)

Question #30 of 73

Question ID: 1573875

A market that directs capital to its most productive use is *best* described as:

A) allocationally efficient.

B) operationally efficient.

C) informationally efficient.

Explanation

Markets are said to be allocationally efficient when capital is directed to its most productive uses. Operationally efficient markets are those that have low trading costs. Informationally efficient markets are those in which security prices reflect all information associated with fundamental value in a timely fashion.

(Module 41.3, LOS 41.k)

Question #31 of 73

Question ID: 1573832

If an investor buys 100 shares of a $50 stock on margin when the initial margin requirement is 40%, how much money must she borrow from her broker?

A) $2,000.

B) $3,000.

C) $4,000.

Explanation

An initial margin requirement of 40% would mean that the investor must put up 40% of the funds and brokerage firm may lend the 60% balance. Therefore, for this example (100 shares) * ($50) = $5,000 total cost. $5,000 * 0.60 = $3,000.

(Module 41.2, LOS 41.f)

Question #32 of 73

Question ID: 1573853

Stop loss sell orders are:

A) executed on an uptick only.

B) placed to protect a short position.

C) placed to protect the gains on a long position.

Explanation

Stop loss sell orders are limit sell orders that are placed below market price. When the share price drops to the designated price, a sell order is executed protecting the investor from further declines.

(Module 41.3, LOS 41.g)

Question #33 of 73

Question ID: 1573878

Peg Fisk, CFA, states that two of the objectives of market regulation which CFA Institute attempts to address are minimum standards of competence among investment professionals and ease of performance evaluation for investors. Fisk is accurate with regard to:

A) both of these objectives.

B) neither of these objectives.

C) only one of these objectives.

Explanation

CFA Institute attempts to address both of these objectives of market regulation. The CFA Program is part of the effort to encourage minimum standards of competency among finance professionals. Global Investment Performance Standards are part of the effort to make performance evaluation easier for investors.

(Module 41.3, LOS 41.l)

Question #34 of 73

Question ID: 1573869

Which of the following statements about securities exchanges is NOT correct?

A) In call markets, there is only one negotiated price set to clear the market for a given stock.

B) In continuous markets, prices are set only by the auction process.

C) Securities exchanges may be structured as call markets or continuous markets.

Explanation

In continuous markets, the price is set by either the auction process or by dealer bid-ask quotes.

(Module 41.3, LOS 41.j)

Question #35 of 73

Question ID: 1573814

The prospectus for the Horizon Fund states that it invests only in real assets. Which of the following would the Horizon Fund *most likely* include in its portfolio?

A) Foreign currencies.

B) Common stock of a technology company.

C) An apartment complex.

Explanation

Real assets are assets with a physical presence such as real estate or equipment and machinery. An investment in an apartment complex is a real estate investment and therefore would be considered a real asset.

(Module 41.1, LOS 41.b)

Question #36 of 73

Question ID: 1573867

Which of the following statements regarding secondary markets is *least* accurate? Secondary markets are important because they provide:

A) firms with greater access to external capital.

B) regulators with information about market participants.

C) investors with liquidity.

Explanation

Secondary markets are important because they provide liquidity and continuous information to investors. The liquidity of the secondary markets adds value to both the investor and firm because more investors are willing to buy issues in the primary market, when they know these issues will later become liquid in the secondary market. Therefore, the secondary market makes it easier for firms to raise external capital.

(Module 41.3, LOS 41.i)

Question #37 of 73

Question ID: 1573837

Sonia Fennell purchases 1,000 shares of Xpressoh Inc. for $35 per share. One year later, she sells the stock for $42 per share. Xpressoh Inc. pays no dividends. The initial margin requirement is 50%. Fennell's one-year return assuming an all-cash transaction, and if she buys on margin (assume she pays no transaction or borrowing costs and has not had to post additional margin), are *closest* to:

	All-cash	50% margin
A)	20%	40%
B)	20%	80%
C)	40%	80%

Explanation

All-cash return = 42/35 – 1 = 20%

Margin return = (42 – 35)/[(35)(0.5)] = 40%

(Module 41.2, LOS 41.f)

Question #38 of 73

Question ID: 1573822

An investor sells a stock short. To protect against a large loss on this position, the investor is *most likely* to:

A) buy a put option.

B) place a stop buy order.

C) set a limit price on the order to sell short.

Explanation

A stop buy order above the current market price would execute if the market price increased to the specified stop price. This would limit the short seller's losses if the stock price increased.

Buying a put option would increase the investor's short exposure to the stock price. Setting a limit price on the order to sell short would affect the price at which the short sale could execute, but it would not limit the short seller's potential losses.

(Module 41.2, LOS 41.e)

Question #39 of 73

Question ID: 1573851

An investor sold a stock short and is worried about rising prices. To protect himself from rising prices he would place a:

A) limit order to buy.

B) stop order to buy.

C) stop order to sell.

Explanation

A limit order to buy is placed below the current market price.

A limit order to sell is placed above the current market price.

A stop (loss) order to buy is placed above the current market price.

A stop (loss) order to sell is placed below the current market price.

A stop order becomes a market order if the price is hit.

(Module 41.3, LOS 41.g)

Question #40 of 73

Question ID: 1573811

Markets for financial assets with maturities of one year or less are *best* characterized as:

A) money markets.

B) primary markets.

C) forward markets.

Explanation

"Money markets" generally refers to markets for debt securities maturing in one year or less. Forward markets refer to contracts for the future exchange of an asset at a price established today. Primary markets are the markets for newly issued securities.

(Module 41.1, LOS 41.b)

Question #41 of 73

Question ID: 1573828

Using the following assumptions, calculate the rate of return on a margin transaction for an investor who purchases the stock and the stock price at which the investor would have received a margin call.

- Market Price Per Share: $32
- Number of Shares Purchased: 1,000
- Holding Period: 1 year
- Ending Share Price: $34
- Initial Margin Requirement: 40%
- Maintenance margin: 25%
- Transaction and borrowing costs: $0
- The company pays no dividends

	Margin Return	Margin Call Price
A)	15.6%	$25.60
B)	15.6%	$17.07
C)	6.3%	$25.60

Explanation

Part 1: Calculate Margin Return:

Margin Return %

= [((Ending Value – Loan Payoff) / Beginning Equity Position) – 1] × 100

= [((([$34 × 1,000] – [$32 × 1,000 × 0.60]) / ($32 × 0.40 × 1,000)) – 1] × 100

= **15.6%**

Alternative (Check): Calculate the all cash return and multiply by the margin leverage factor.

[(34,000 – 32,000) / 32,000] × [1 / 0.40] = 6.35% × 2.5 = **15.6%**

Part 2: Calculate Margin Call Price:

The formula for the margin call price is:

Margin Call = (original price) × (1 - initial margin) / (1 - maintenance margin)

= $32 × (1 - 0.40) / (1 - 0.25) = approximately **$25.60**

(Module 41.2, LOS 41.f)

Question #42 of 73

Question ID: 1573835

Which of the following statements regarding margin accounts is *most accurate*?

A) Maintenance margin refers to the amount of funds the investor can borrow.

B) Margin accounts can be used to purchase securities by borrowing part of the purchase price.

C) The total equity in the margin account cannot fall below the initial margin requirement.

Explanation

Margin accounts are brokerage accounts that allow investors to borrow part of the purchase price from the broker.

(Module 41.2, LOS 41.f)

Question #43 of 73

Question ID: 1573812

Among the classifications of investment assets, "real assets" *most likely* include:

A) foreign currencies.

B) durable equipment.

C) industrial stocks.

Explanation

Real assets include real estate, durable equipment, and other physical assets. Equity securities such as industrial stocks are classified as financial assets. Currencies are a separate classification of investment assets.

(Module 41.1, LOS 41.b)

Question #44 of 73

Question ID: 1573873

Which of the following is *least* likely a characteristic of a well-functioning market?

A) Reliable information is available on price and volume.

B) Prices change significantly from one transaction to the next.

C) Prices adjust quickly when new information becomes available.

Explanation

In a well-functioning market, prices should not typically change much from one transaction to the next because many buyers and sellers are willing to trade at prices near the current price. Characteristics of a well-functioning market include availability of reliable information on prices and transaction volume; liquidity (marketability and price continuity); prices that react quickly to new information; and low transactions costs.

(Module 41.3, LOS 41.k)

Question #45 of 73

Question ID: 1573849

An investor purchased 725 shares of stock at $40 per share and posted initial margin of 60%. He subsequently sold the shares at $50 per share. Based only on this information, the investor's holding period return is *closest to*:

A) 20%.

B) 25%.

C) 40%.

Explanation

(50 – 40) / (40 × 0.6) = 41.67%.

(Module 41.2, LOS 41.f)

Question #46 of 73

Question ID: 1573866

Which of the following statements about primary and secondary markets is *least* accurate?

A) A primary market is a market in which new securities are sold.

B) The proceeds from a sale in the secondary market go to the issuer.

C) The primary market benefits from the liquidity provided by the secondary market.

Explanation

Proceeds in a primary market go to the issuing firm. Proceeds from a sale in the secondary market go to the current owner who is selling the securities.

(Module 41.3, LOS 41.i)

Question #47 of 73

Question ID: 1573827

When using margin to invest in equities, which of the following defines initial margin and what level will the margin be brought back to in the event of a margin call?

	Initial Margin	Margin Call Action
A)	minimum amount of equity required of the investor	a deposit must be made to bring the margin back to the initial margin
B)	minimum amount of equity required of the investor	a deposit must be made to bring the margin back to the maintenance margin
C)	amount of borrowed funds in the transactions	a deposit must be made to bring the margin back to the maintenance margin

Explanation

The initial margin requirement refers to the minimum amount of equity required of the investor.

With equities, if the margin falls below the maintenance margin, funds must be deposited to bring it back up to the maintenance margin level.

(Module 41.2, LOS 41.f)

Question #48 of 73

Question ID: 1573807

The main functions of the financial system *least likely* include:

A) allocating financial resources to their most productive uses.

B) bringing together savers and borrowers.

C) preventing investors from generating abnormal profits by trading on information.

Explanation

One of the purposes of the financial system is to allow investors to trade on (public) information. Other purposes of the financial system include allocating financial capital to its most productive uses, and bringing together those who wish to save with those who wish to borrow.

(Module 41.1, LOS 41.a)

Question #49 of 73

Question ID: 1573815

Which of the following assets are *best* characterized as contracts?

A) Commercial paper.

B) Currency swaps.

C) Depository receipts.

Explanation

Contracts include forwards, futures, options, swaps, and insurance contracts. Commercial paper is a debt security. Depository receipts are shares in a pooled investment vehicle, such as a mutual fund or an exchange-traded fund.

(Module 41.1, LOS 41.c)

Question #50 of 73

Question ID: 1573876

With respect to a well-functioning securities market, a market that exhibits operational efficiency will have:

A) price continuity.

B) low transaction costs.

C) rapid price reactions to new information.

Explanation

An operationally efficient market is a market in which the cost of each transaction is minimal. Informational efficiency means prices in the market reflect all information currently available to participants. Price continuity means that prices do not adjust much from one transaction to the next unless new information about firm value becomes available.

(Module 41.3, LOS 41.k)

Question #51 of 73

Question ID: 1573855

Evelyn Stram, CFA, places a good-till-cancelled limit buy order at 86 for a stock. Stram's order specifies:

A) validity and execution instructions. ✓

B) execution and clearing instructions. ✗

C) clearing and validity instructions. ✗

Explanation

Good-till-cancelled is a validity instruction, which indicates when an order may be filled. Execution instructions include limit orders and market orders, as well as instructions regarding trade size and visibility. A clearing instruction indicates how to arrange final settlement of the trade.

(Module 41.3, LOS 41.g)

Question #52 of 73

Question ID: 1573821

Regarding the technical points affecting the short sales of a stock, which of the following statements is *most* accurate?

A) Stocks can only be shorted in a down market. ✗

B) The lender must deposit margin to guarantee the eventual return of the stock. ✗

C) The short seller must pay all dividends due to the lender of the shorted stock. ✓

Explanation

The short seller must pay any dividends on the stock to the owner of the borrowed shares. The short seller must also deposit margin money to guarantee the eventual repurchase of the security.

(Module 41.2, LOS 41.e)

Question #53 of 73

Question ID: 1573825

Which of the following option positions is said to be a long position?

A) Writer of a call option.

B) Writer of a put option.

C) Buyer of a put option.

Explanation

The buyer of an option (either a call or put) is said to be long the option and the writer of an option is said to be short the option. Note that with put options, the long (put option holder) benefits when the price of the underlying asset decreases, while the short (put option writer) benefits when the price of the underlying asset increases. We say that a put buyer is long the option but has short exposure to the underlying asset price.

(Module 41.2, LOS 41.e)

Question #54 of 73

Question ID: 1573872

An electronic crossing network is *best* described as:

A) an order-driven market.

B) a quote-driven market.

C) a price-driven market.

Explanation

A crossing network is an example of an order-driven market. Orders are batched together and crossed (matched) at specific times during the trading day at prices based on those of another exchange. Price-driven markets and quote-driven markets are other terms for dealer or over-the-counter markets.

(Module 41.3, LOS 41.j)

Question #55 of 73

Question ID: 1573808

The main functions of the financial system *most likely* include:

A) allocating capital to its most productive uses and determining the supply of money.

B) determining equilibrium interest rates and allocating capital to its most productive uses.

C) determining the supply of money and determining equilibrium interest rates.

Explanation

The main functions of the financial system are to allow individuals and organizations to save, borrow, raise capital, and manage risks; to determine equilibrium rates of return that equate the amounts of lending and borrowing; and to allocate capital to its most productive uses. The money supply is typically controlled by countries' central banks.

(Module 41.1, LOS 41.a)

Question #56 of 73

Question ID: 1573871

A unique item such as fine art is *most likely* to be exchanged in a(n):

A) brokered market.

B) order-driven market.

C) quote-driven market.

Explanation

Brokered markets are typically the best market structure for unique items. A broker adds value by locating a counterparty to take the opposite side of a trade of such an item.

(Module 41.3, LOS 41.j)

Question #57 of 73

Question ID: 1573839

An investor buys 1,000 shares of a non-dividend-paying stock for $18. The initial margin requirement is 40% and the maintenance margin is 30%. After one year the investor sells the stock for $24 per share. The investor's rate of return on this investment (ignoring borrowing and transactions costs and taxes), and the price at which the investor would receive a margin call, are *closest to:*

	Rate of return	Margin call
A)	83%	$15.43
B)	83%	$21.00
C)	33%	$15.43

Explanation

To obtain the result:

Part 1: Calculate Margin Return:

Margin Return % = [((Ending Value - Loan Payoff) / Beginning Equity Position) – 1] * 100 =

= [((\[$24 × 1,000] – [$18 × 1,000 × 0.60]) / ($18 × 0.40 × 1,000)) – 1] × 100 =

= **83.33%**

Alternative (Check):

Calculate the all cash return and multiply by the margin leverage factor.

= [(24,000 – 18,000)/18,000] × [1 / 0.40] = 33.33% × 2.5 = 83.33%

Part 2: Calculate Margin Call Price:

Since the investor is *long* (purchased the stock), the formula for the margin call price is:

Margin Call = (original price) × (1 – initial margin) / (1 – maintenance margin)

= $18 × (1 – 0.40) / (1 – 0.30) = **$15.43**

(Module 41.2, LOS 41.f)

Question #58 of 73

Question ID: 1573846

An investor purchases 200 shares of Mertz, Inc. on margin. The shares are trading at $40. Initial and maintenance margins are 50% and 25%. If the investor sells the stock when the price rises to $50 at year-end, the return on the investment would be *closest* to:

A) 20%.

B) 50%.

C) 25%.

Explanation

Profit = 10,000 – 8,000 = 2,000

Return = 2,000 / 4,000 = 50%

(Module 41.2, LOS 41.f)

Question #59 of 73

Question ID: 1573858

Which of the following statements about securities markets is *least* accurate?

A) Characteristics of a well-functioning securities market *include*: many buyers and sellers, low bid-ask spreads, timely information on price and volume of past transactions, and accurate information on supply and demand.

B) A limit buy order and a stop buy order are both placed below the current market price.

C) Secondary markets, such as the over-the-counter (OTC) market, provide liquidity and price continuity.

Explanation

A limit buy is placed below the current market price, but a stop buy order is placed *above* the current market price (stop buy orders are often placed to protect a short sale from a rising market).

The other choices are true. A well-functioning securities market includes the following characteristics:

- timely and accurate information on price and volume of past transactions.
- timely and accurate information on the supply and demand for current transactions.
- liquidity (as indicated by low bid-ask spreads).
- marketability.
- price continuity.
- depth (many buyers and sellers).
- operational efficiency (low transaction costs).
- informational efficiency (rapidly adjusting prices).

(Module 41.3, LOS 41.h)

Question #60 of 73

Question ID: 1573841

An investor purchases 100 shares of Lloyd Computer at $26 a share. The initial margin requirement is 50%, and the maintenance margin requirement is 25%. The price below which the investor would receive a margin call is *closest* to:

A) 17.33.

B) 15.25.

C) 19.45.

Explanation

26 × (1 - 0.5)/(1 - 0.25) = $17.33.

(Module 41.2, LOS 41.f)

Question #61 of 73

Question ID: 1573816

Equity securities *most likely* include:

A) preferred stock and certificates of deposit.

B) common stock and warrants.

C) exchange-traded funds.

Explanation

Common stock, preferred stock, and warrants are equity securities. Certificates of deposit are debt securities. Exchange-traded funds are pooled investment vehicles.

(Module 41.1, LOS 41.c)

Question #62 of 73

Question ID: 1573864

A primary market transaction involves:

A) the sale of new securities to investors.

B) investment-grade bonds or preferred stocks.

C) direct trading of securities between institutional investors.

Explanation

A primary market is a market for new issues of securities.

(Module 41.3, LOS 41.i)

Question #63 of 73

Question ID: 1573824

A short seller:

A) does not receive the dividends. ✓

B) loses if the price of the stock sold short decreases. ✗

C) often also places a stop loss sell order. ✗

Explanation

The short seller pays all dividends to the lender, loses if stock prices *rise*, and is required to post a margin account. A short seller often places a *stop buy* order to protect the short sale position from a rising market.

(Module 41.2, LOS 41.e)

Question #64 of 73

Question ID: 1573823

Which of the following statements about selling a stock short is *least likely* accurate?

A) The seller must inform their broker that the order is a short sale before completing the transaction. ✗

B) The short seller may withdraw the proceeds of the short sale. ✓

C) The seller must return the securities at the request of the lender. ✗

Explanation

Proceeds from the short sale must remain in the brokerage account along with the required margin deposit.

(Module 41.2, LOS 41.e)

Question #65 of 73

Question ID: 1573810

Jerry Slotz enters an exchange-traded contract that obligates him to purchase a specific amount of an asset on a future date. The contract is *most likely*:

A) a futures contract.

B) a forward contract.

C) an option contract.

Explanation

Futures contracts are standardized contracts traded on an exchange that obligate one party to purchase and one party to sell a specific amount of an asset at a specified price on a specified future date. Forward contracts are similar to futures contracts but are customizable (i.e., not standardized) and traded over-the-counter (i.e., not exchange-traded). Call options can be traded on an exchange; however, they give the holder the right, not the obligation, to purchase the asset at a future date.

(Module 41.1, LOS 41.a)

Question #66 of 73

Question ID: 1573819

Financial intermediaries that issue securities which represent interests in a pool of similar financial assets are *best* characterized as:

A) arbitrageurs.

B) block brokers.

C) securitizers.

Explanation

Securitizers are financial intermediaries that assemble large pools of similar financial assets, such as mortgages or loans, and issue securities that represent interests in the pool. Block brokers assist their clients with large trades of securities. Arbitrageurs simultaneously buy and sell the same asset in different markets to take advantage of different prices for the same asset.

(Module 41.1, LOS 41.d)

Question #67 of 73

Question ID: 1573813

A securities exchange where traders buy and sell long-term government bonds from and to other traders would *best* be described as part of the:

A) capital market.

B) money market.

C) primary market.

Explanation

The exchange can be described as part of the secondary capital markets. A security is first issued in the primary market, and then it trades among investors in the secondary market. The money market refers to the market for short-term debt instruments (usually with maturities of less than one year) such as T-bills.

(Module 41.1, LOS 41.b)

Question #68 of 73

Question ID: 1573831

An investor buys 200 shares of ABC at the market price of $100 on full margin. The initial margin requirement is 40% and the maintenance margin requirement is 25%.

If the shares of stock later sold for $200 per share, what is the rate of return on the margin transaction?

A) 100%.

B) 250%.

C) 400%.

Explanation

One quick (and less than intensive) way to calculate the answer to this on the examination (and it is very important to save time on the examination) is to first calculate the return if all cash, then calculate the margin leverage factor and then finally, multiply the leverage factor times the all cash return to obtain the margin return.

Calculations:

Step 1: Calculate All Cash Return:

Cash Return % = [(Ending Value / Beginning Equity Position) – 1] × 100

= [(($200 × 200) / ($100 × 200)) – 1] × 100 = **100%**

Step 2: Calculate Leverage Factor:

Leverage Factor = 1 / Initial Margin % = 1 / 0.40 = **2.50**

Step 3: Calculate Margin Return:

Margin Transaction Return = All cash return × Leverage Factor = 100% × 2.50 = **250%**

Note: You can verify the margin return as follows:

Margin Return % = [((Ending Value – Loan Payoff) / Beginning Equity Position) – 1] × 100

= [(([$200 × 200] – [$100 × 200 × 0.60]) / ($100 × 0.40 × 200)) – 1] × 100

= [((40,000 – 12,000) / 8,000) – 1] × 100 = **250%**

(Module 41.2, LOS 41.f)

Question #69 of 73

Question ID: 1573857

An order to sell a security at the best price available is a:

A) market order. ✓

B) stop order. ✗

C) limit order. ✗

Explanation

A market order is an order to buy or sell a security immediately at the best available price. A limit order is an order to buy at the specified limit price or lower, or to sell at the limit price or higher. A stop order is an order to buy if the market price increases to the specified stop price, or to sell if the market price decreases to the stop price.

(Module 41.3, LOS 41.h)

Question #70 of 73

Question ID: 1573834

The initial margin is the:

A) minimum amount of funds that must be supplied when purchasing a security on margin.

B) equity represented in the margin account at any time.

C) amount of cash that an investor must maintain in his/her margin account.

Explanation

Margin is the amount of equity in the account at a given time. Initial margin is the amount of equity required initially to execute an order.

(Module 41.2, LOS 41.f)

Question #71 of 73

Question ID: 1573842

An investor buys 200 shares of ABC at the market price of $100 and posts the required initial margin of $8,000. The maintenance margin requirement is 25%.

At what share price will the investor's account balance be reduced to the maintenance margin level?

A) $48.

B) $80.

C) $112.

Explanation

The initial margin requirement is $8,000 / (200 × $100) = 0.40. In a long stock position, the equation to determine the margin call price is:

long = [(original price)(1 – initial margin %)] / [1 – maintenance margin %]

= $100(1 – 0.4) / (1 – 0.25) = $80

Alternatively, the margin loan is (200 × $100) – $8,000 = $12,000. The minimum value of the long position that meets the maintenance margin requirement is $12,000 / (1 – 0.25) = $16,000. The share price at which the long position has this value is $16,000 / 200 = $80.

(Module 41.2, LOS 41.f)

Question #72 of 73

Question ID: 1573863

Compared to a market order to sell, a limit order to sell will specify:

A) a price that can be higher or lower than the current market price.

B) a minimum price equal to or less than the current market price.

C) a maximum price above the current market price.

Explanation

Price limits on buy or sell orders can be above, at, or below the current market price.

(Module 41.3, LOS 41.h)

Question #73 of 73

Question ID: 1573862

Which of the following limit orders is *least likely* to be filled?

A) Inside-the-market limit sell order.

B) Aggressively priced limit buy order.

C) Behind-the-market limit buy order.

Explanation

"Behind the market" refers to a buy order with a limit price less than the best bid, or a sell order with a limit price higher than the best ask. A limit order that is behind the market (i.e., an order to buy for less than the market price or sell for more than the market price) will not be filled unless the market price moves to the order's limit price. "Inside the market" refers to orders with limit prices between the best bid and best ask. "Aggressively priced" refers to a buy order with limit prices higher than the best ask or a sell order with a limit price lower than the best bid. Aggressively priced limit orders are most likely to be filled immediately.

(Module 41.3, LOS 41.h)