Derivative Markets and Instruments

Test ID: 7697683

Question #1 of 60

Question ID: 456306

Which of the following statements about futures and the clearinghouse is *least* accurate? The clearinghouse:

✓ **A) has defaulted on one half of one percent of futures trades.**

✗ **B)** requires the daily settlement of all margin accounts.

✗ **C)** guarantees that traders in the futures market will honor their obligations.

Explanation

In the history of U.S. futures trading, the clearinghouse has never defaulted.

The clearinghouse guarantees that traders in the futures market will honor their obligations. The clearinghouse does this by splitting each trade once it is made and acting as the opposite side of each position. The clearinghouse acts as the buyer to every seller and the seller to every buyer. By doing this, the clearinghouse allows either side of the trade to reverse positions later without having to contact the other side of the initial trade. This allows traders to enter the market knowing that they will be able to reverse their position any time that they want. Traders are also freed from having to worry about the other side of the trade defaulting, since the other side of their trade is now the clearinghouse.

To safeguard the clearinghouse, the exchange requires traders to post margin and settle their accounts on a daily basis.

Question #2 of 60

Question ID: 456308

Which of the following is a difference between futures and forward contracts? Futures contracts are:

✗ **A) larger than forward contracts.**

✗ **B)** over-the-counter instruments.

✓ **C)** standardized.

Explanation

As opposed to forward contracts, futures contracts are traded over an organized exchange and are standardized in size, maturity, quality of deliverable, etc.

Question #3 of 60

Question ID: 415818

If the margin balance in a futures account with a long position goes below the maintenance margin amount:

✓ **A) a deposit is required to return the account margin to the initial margin level.**

✗ **B)** a deposit is required which will bring the account to the maintenance margin level.

✗ **C)** a margin deposit equal to the maintenance margin is required within two business days.

Explanation

Once account margin (based on the daily settlement price) falls below the maintenance margin level, it must be returned to the initial margin level, regardless of subsequent price changes.

Question #4 of 60

Question ID: 415742

The party to a forward contract that is obligated to purchase the asset is called the:

✓ **A)** **long.**

✗ **B)** short.

✗ **C)** receiver.

Explanation

The long in a forward contract is obligated to buy the asset (in a deliverable contract). The term receiver is used with swaps.

Question #5 of 60

Question ID: 415988

In a plain vanilla interest rate swap:

✓ **A)** **one party pays a floating rate and the other pays a fixed rate, both based on the notional amount.**

✗ **B)** each party pays a fixed rate of interest on a notional amount.

✗ **C)** payments equal to the notional principal amount are exchanged at the initiation of the swap.

Explanation

A plain vanilla swap is a fixed-for-floating swap.

Question #6 of 60

Question ID: 415732

Which of the following relationships between arbitrage and market efficiency is *least* accurate?

✗ **A)** **Investors acting on arbitrage opportunities help keep markets efficient.**

✓ **B)** Market efficiency refers to the low cost of trading derivatives because of the lower expense to traders.

✗ **C)** The concept of rationally priced financial instruments preventing arbitrage opportunities is the basis behind the no-arbitrage principle.

Explanation

Market efficiency is achieved when all relevant information is reflected in asset prices, and does not refer to the cost of trading. One necessary criterion for market efficiency is rapid adjustment of market values to new information. Arbitrage, trading on a price difference between identical assets, causes changes in demand for and supply of the assets that tends to eliminate the pricing difference.

Question #7 of 60

Question ID: 434429

A 4 percent Treasury bond has 2.5 years to maturity. Spot rates are as follows:

6 month	*1 year*	*1.5 years*	*2 years*	*2.5 years*

2%	2.5%	3%	4%	6%

The note is currently selling for $976. Determine the arbitrage profit, if any, that is possible.

✓ **A) $19.22.**

✗ **B)** $37.63.

✗ **C)** $43.22.

Explanation

$$= \frac{20}{1.01} + \frac{20}{1.0125^2} + \frac{20}{1.015^3} + \frac{20}{1.02^4} + \frac{1020}{1.03^5}$$
$$= 19.80 + 19.51 + 19.13 + 18.48 + 879.86 = \$956.78$$
$$= 976 - 956.78 = \$19.22$$

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Question ID: 415717

Typically, forward commitments are made with respect to all the following EXCEPT:

✓ **A) inflation.**

✗ **B)** equities.

✗ **C)** bonds.

Explanation

Forward commitments can be customized and *could* be written on some measure of inflation, but typically they are not. The volume of forward commitments, including forward contracts and futures contracts, on bonds, equities, and interest rates is in the many billions of dollars.

Question #9 of 60

Question ID: 415797

Which of the following is *least likely* a characteristic of futures contracts? Futures contracts:

✗ **A) are backed by the clearinghouse.**

✓ **B)** require weekly settlement of gains and losses.

✗ **C)** are traded in an active secondary market.

Explanation

Futures contracts require *daily* settlement of gains and losses. The other statements are accurate.

Question #10 of 60

Question ID: 456307

The clearinghouse, in U.S. futures markets is *least likely* to:

✗ **A) guarantee performance of futures contract obligations.**

✓ **B)** choose which assets will have futures contracts.

✗ **C)** act as a counterparty in futures contracts.

Explanation

The *exchange* decides which contracts will be traded and their specifications. The clearinghouse acts as the counterparty to every contract and guarantees performance.

Question #11 of 60

Question ID: 456305

Which of the following statements about forward contracts is *least* accurate?

✗ **A) The long promises to purchase the asset.**

✗ **B)** Both parties to a forward contract have potential default risk.

✓ **C)** A forward contract can be exercised at any time.

Explanation

Forward contracts typically require a purchase/sale of the asset on the expiration/delivery date specified in the contract. The other statements are true.

Question #12 of 60

Question ID: 415736

Which of the following is the *best* interpretation of the no-arbitrage principle?

✗ **A) The information flow is quick in the financial market.**

✓ **B)** There is no free money.

✗ **C)** There is no way you can find an opportunity to make a profit.

Explanation

An *arbitrage opportunity* is the chance to make a riskless profit with no investment. *In essence, finding an arbitrage opportunity is like finding free money.* As you recall, in arbitrage, you observe two identical assets with different prices. Your immediate response should be to buy the cheaper one and sell the expensive one short. You can then deliver the cheap one to cover your short position. Once you take the initial arbitrage position, your arbitrage profit is locked in. The *no-investment statement* referenced in the text refers to the assumption that when you short the expensive asset, you will be given access to the cash created by the short sale. With this cash, you now have the money to buy the cheaper asset. The no-investment assumption means that the first person to observe a market pricing error will have the financial resources to correct the pricing error instantaneously all by themselves.

Question #13 of 60

Question ID: 415802

Which of the following statements regarding futures and forward contracts is *least* accurate?

✗ **A) Futures contracts are highly standardized.**

✗ **B)** Forwards require no cash transactions until the delivery date, while futures require a margin deposit when the position is opened.

✓ **C)** Both forward contracts and futures contracts trade on organized exchanges.

Explanation

Forward contracts are custom-tailored contracts and are not exchange traded while futures contracts are standardized and are traded on an organized exchange.

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Question ID: 415745

Some forward contracts are termed *cash settlement* contracts. This means:

✓ **A)** **either the long or the short in the forward contract will make a cash payment at contract expiration and the asset is not delivered.**

✗ **B)** at contract expiration, the long can buy the asset from the short or pay the difference between the market price of the asset and the contract price.

✗ **C)** at settlement, the long purchases the asset from the short for cash.

Explanation

In a cash settlement forward contract there is a cash payment at settlement by either the long or the short depending on whether the market price of the asset is below or above the contract price at expiration. The underlying asset is not purchased or sold at settlement.

Question #15 of 60

Question ID: 415710

A financial instrument that has payoffs based on the price of an underlying physical or financial asset is a(n):

✓ **A)** **derivative security.**

✗ **B)** future.

✗ **C)** option.

Explanation

Options and futures are examples of types of derivative securities.

Question #16 of 60

Question ID: 415722

An agreement that gives the holder the right, but not the obligation, to sell an asset at a specified price on a specific future date is a:

✓ **A)** **put option.**

✗ **B)** call option.

✗ **C)** swap.

Explanation

A put option gives the holder the right to sell an asset at a specified price on a specific future date. A call option gives the holder the right to buy an asset at a specified price on a specific future date. A swap is an obligation to both parties.

Question #17 of 60

Question ID: 415804

Standardized futures contracts are an aid to increased market liquidity because:

✗ **A) standardization results in less trading activity.**

✗ **B)** standardization of the futures contract stabilizes the market price of the underlying commodity.

✓ **C)** uniformity of the contract terms broadens the market for the futures by appealing to a greater number of traders.

Explanation

Although a forward may have value to someone other than the original counterparties, the non-standardized terms limit the level of interest, hence its marketability and liquidity. The standardized terms of a future give it far more flexibility to traders, giving rise to a strong secondary market and greater liquidity.

Question #18 of 60

Question ID: 415727

Which of the following statements about arbitrage is NOT correct

✗ **A) No investment is required when engaging in arbitrage.**

✗ **B)** If an arbitrage opportunity exists, making a profit without risk is possible.

✓ **C)** Arbitrage can cause markets to be less efficient.

Explanation

Arbitrage is defined as the existence of riskless profit without investment and involves selling an asset and simultaneously buying the same asset for a lower price. Since the trades cancel each other, no investment is required. Because it is done simultaneously, a profit is guaranteed, making the transaction risk free. Arbitrage actually helps make markets more efficient because price discrepancies are immediately eradicated by the actions of arbitrageurs.

Question #19 of 60

Question ID: 415744

Default risk in a forward contract:

✗ **A) only applies to the short, who must make the cash payment at settlement.**

✗ **B)** only applies to the long, and is the probability that the short can not acquire the asset for delivery.

✓ **C)** is the risk to either party that the other party will not fulfill their contractual obligation.

Explanation

Default risk in forward contracts is the risk to either party that the other party will not perform, whether that means pay cash or deliver the asset.

Question #20 of 60

Question ID: 415733

Which of the following statements about arbitrage opportunities is CORRECT?

✗ **A) Engaging in arbitrage requires a large amount of capital for the investment.**

✗ **B)** When an opportunity exists to profit from arbitrage, it usually lasts for several trading days.

✓ **C)** Pricing errors in securities are instantaneously corrected by the first arbitrageur to recognize them.

Explanation

Arbitrage is the opportunity to trade in identical assets that are momentarily selling for different prices. Arbitrageurs act quickly to make a riskless profit, causing the price discrepancy to be instantaneously corrected. No capital is required, because opposite trades are made simultaneously.

Question #21 of 60

Question ID: 415718

A legally binding promise to buy 140 oz. of gold two months from now at a price agreed upon today is a(n):

✗ **A) take-or-pay contract.**

✗ **B)** hedge.

✓ **C)** forward commitment.

Explanation

It is a forward commitment; it may be used to hedge or may be used to speculate on the price of gold in two months.

Question #22 of 60

Question ID: 415817

The settlement price for a futures contract is:

✓ **A) an average of the trade prices during the 'closing period'.**

✗ **B)** the price of the last trade of a futures contract at the end of the trading day.

✗ **C)** the price of the asset in the future for all trades made in the same day.

Explanation

The margin adjustments are made based on the settlement price, which is calculated as the average trade price over a specific closing period at the end of the trading day. The length of the closing period is set by the exchange.

Question #23 of 60

Question ID: 415728

Which of the following is a common criticism of derivatives?

✓ **A) Derivatives are likened to gambling.**

✗ **B)** Derivatives are too illiquid.

✗ **C)** Fees for derivatives transactions are relatively high.

Explanation

Derivatives are often likened to gambling by those unfamiliar with the benefits of options markets and how derivatives are used.

Question #24 of 60

Question ID: 415853

A European option can be exercised by:

✓ **A)** **its owner, only at the expiration of the contract.**

✗ **B)** its owner, anytime during the term of the contract.

✗ **C)** either party, at contract expiration.

Explanation

A European option can be exercised by its owner only at contract expiration.

Question #25 of 60

Question ID: 415711

A derivative security:

✗ **A)** **has a value based on stock prices.**

✓ **B)** has a value based on another security or index.

✗ **C)** has no default risk.

Explanation

This is the definition of a derivative security. Those based on stock prices are equity derivatives.

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Question ID: 415740

An analyst determines that a portfolio with a 35% weight in Investment P and a 65% weight in Investment Q will have a standard deviation of returns equal to zero.

- Investment P has an expected return of 8%.
- Investment Q has a standard deviation of returns of 7.1% and a covariance with the market of 0.0029.
- The risk-free rate is 5% and the market risk premium is 7%.

If no arbitrage opportunities are available, the expected rate of return on the combined portfolio is *closest to*:

✗ **A)** **6%.**

✗ **B)** 7%.

✓ **C)** 5%.

Explanation

If the no-arbitrage condition is met, a riskless portfolio (a portfolio with zero standard deviation of returns) will yield the risk-free rate of return.

Question #27 of 60

Question ID: 415849

Regarding buyers and sellers of put and call options, which of the following statements concerning the resulting option position is *most* accurate? The buyer of a:

✗ **A) call option is taking a long position and the buyer of a put option is taking a short position.**

✗ **B)** put option is taking a short position and the seller of a call option is taking a short position.

✓ **C)** call option is taking a long position while the seller of a put is taking a short position.

Explanation

The buyers of both puts and calls are taking long positions in the options contracts (but the buyer of a put is establishing a potentially short exposure to the underlying), while writers (sellers) of each are taking short positions in the options contracts.

Question #28 of 60

Question ID: 472436

Sally Ferguson, CFA, is a hedge fund manager. Ferguson utilizes both futures and forward contracts in the fund she manages. Ferguson makes the following statements about futures and forward contracts:

> Statement 1: A futures contract is an exchange traded instrument with standardized features.
> Statement 2: Forward contracts are marked to market on a daily basis to reduce credit risk to both counterparties.

Are Ferguson's statements accurate?

✗ **A) Both of these statements are accurate.**

✗ **B)** Neither of these statements is accurate.

✓ **C)** Only one of these statements is accurate.

Explanation

Statement 1 is correct. A futures contract is a standardized instrument that is traded on an exchange, unlike a forward contract which is a customized transaction. Statement 2 is incorrect. A forward contract is not marked to market.

Question #29 of 60

Question ID: 415851

Which of the following represents a long position in an option?

✗ **A) Writing a call option.**

✓ **B)** Buying a put option.

✗ **C)** Writing a put option.

Explanation

A long position is always the buying position. Remember that the buyer of an option is said to have gone long the position, while the writer (seller) of the option is said to have gone short the position.

Question #30 of 60

Question ID: 415735

Any rational quoted price for a financial instrument should:

✓ **A) provide no opportunity for arbitrage.**

✗ **B)** provide an opportunity for investors to make a profit.

✗ **C)** be low enough for most investors to afford.

Explanation

Since any observed pricing errors will be instantaneously corrected by the first person to observe them, any quoted price must be free of all known errors. This is the basis behind the text's *no-arbitrage principle*, which states that any rational price for a financial instrument must exclude arbitrage opportunities. The no-arbitrage opportunity assumption is the basic requirement for rational prices in the financial markets. This means that markets and prices are efficient. That is, all relevant information is impounded in the asset's price. With arbitrage and efficient markets, you can create the option and futures pricing models presented in the text.

Question #31 of 60

Question ID: 415737

The process that ensures that two securities positions with identical future payoffs, regardless of future events, will have the same price is called:

✓ **A)** **arbitrage.**
✗ **B)** exchange parity.
✗ **C)** the law of one price.

Explanation

If two securities have identical payoffs regardless of events, the process of arbitrage will move prices toward equality. Arbitrageurs will buy the lower priced position and sell the higher priced position, for an immediate profit without any future liability. The law of one price (for securities with identical payoffs) is not a process; it is 'enforced' by arbitrage.

Question #32 of 60

Question ID: 415725

MBT Corporation recently announced a 15% increase in earnings per share (EPS) over the previous period. The consensus expectation of financial analysts had been an increase in EPS of 10%. After the earnings announcement the value of MBT common stock increased each day for the next five trading days, as analysts and investors gradually reacted to the better than expected news. This gradual change in the value of the stock is an example of:

✗ **A)** **speculation.**
✗ **B)** efficient markets.
✓ **C)** inefficient markets.

Explanation

A critical element of efficient markets is that asset prices respond immediately to any new information that will affect their value. Large numbers of traders responding in similar fashion to the new information will create a temporary imbalance in supply and demand, and this will adjust asset market values.

Question #33 of 60

Question ID: 415726

Financial derivatives contribute to market completeness by allowing traders to do all of the following EXCEPT:

✗ **A)** **engage in high risk speculation.**

✗ **B)** increase market efficiency through the use of arbitrage.

✓ **C)** narrow the amount of trading opportunities to a more manageable range.

Explanation

Financial derivatives increase the opportunities to either speculate or hedge on the value of underlying assets. This adds to market completeness by increasing the range of identifiable payoffs that can be used by traders to fulfill their needs. Financial derivatives such as market index futures can also be easier and cheaper than trading in a diversified portfolio, thereby adding to the opportunities available to traders.

Question #34 of 60

Question ID: 415730

One reason that criticism has been leveled at derivatives and derivatives markets is that:

✗ **A)** **derivatives expire.**

✓ **B)** they are complex instruments and sometimes hard to understand.

✗ **C)** derivatives have too much default risk.

Explanation

The fact that derivative securities are sometimes complex and often hard for non-financial commentators to understand has led to criticism of derivatives and derivative markets.

Question #35 of 60

Question ID: 415855

What is the primary difference between an American and a European option?

✗ **A)** **American and European options are never written on the same underlying asset.**

✓ **B)** The American option can be exercised at anytime on or before its expiration date.

✗ **C)** The European option can only be traded on overseas markets.

Explanation

American and European options are virtually identical, except exercising the European option is limited to its expiration date only. The American option can be exercised at anytime on or before its expiration date. For the exam, the key concept relating to this difference is the value of the American option must be equal or greater than the value of the corresponding European option, all else being equal.

Question #36 of 60

Question ID: 415746

A forward contract that must be settled by a sale of an asset by one party to the other party is termed a:

✗ **A)** **physicals-only contract.**

✓ **B)** deliverable forward contract.

✗ **C)** take-and-pay contract.

Explanation

A deliverable forward contract can be settled at expiration only by actual delivery of the asset in exchange for the contract value. The other terms are made up.

Question #37 of 60

Question ID: 415714

Which of the following is NOT an over-the-counter (OTC) derivative?

- ✗ **A)** **A bond option.**
- ✓ **B)** A futures contract.
- ✗ **C)** A forward contract.

Explanation

Futures contracts are exchange-traded; forwards and most bond options are OTC derivatives.

Question #38 of 60

Question ID: 415734

Which of the following is *least likely* one of the conditions that must be met for a trade to be considered an arbitrage?

- ✗ **A)** **There is no initial investment.**
- ✓ **B)** There are no commissions.
- ✗ **C)** There is no risk.

Explanation

In order to be considered arbitrage there must be no risk in the trade.

It doesn't matter if commissions are paid as long as the amount of the price discrepancy is enough to offset the amount paid in commissions.

In order to be considered arbitrage there must be no initial investment of one's own capital. One must finance any cash outlay through borrowing.

Question #39 of 60

Question ID: 415738

Which of the following is an example of an arbitrage opportunity?

- ✗ **A)** **A put option on a share of stock has the same price as a call option on an identical share.**
- ✗ **B)** A stock with the same price as another has a higher rate of return.
- ✓ **C)** A portfolio of two securities that will produce a certain return that is greater than the risk-free rate of interest.

Explanation

An arbitrage opportunity exists when a combination of two securities will produce a certain payoff in the future that produces a return that is greater than the risk-free rate of interest. Borrowing at the riskless rate to purchase the position will produce a certain future amount greater than the amount required to repay the loan.

Question #40 of 60

Question ID: 415794

Which of the following statements about futures is *least* accurate?

- ✗ **A) Futures contracts have a maximum daily allowable price limit.**
- ✗ **B)** The futures exchange specifies the minimum price fluctuation of a futures contract.
- ✓ **C)** The exchange-mandated uniformity of futures contracts reduces their liquidity.

Explanation

The exchange-mandated uniformity of futures contracts *increases* their liquidity.

Question #41 of 60

Question ID: 415716

Which of the following is *most* accurate regarding derivatives?

- ✗ **A) Exchange-traded derivatives are created and traded by dealers in a market with no central location.**
- ✗ **B)** Derivatives have no default risk.
- ✓ **C)** Derivative values are based on the value of another security, index, or rate.

Explanation

Derivatives "derive" their value from the value or return of another asset or security. Exchange-traded derivatives are standardized and backed by a clearinghouse. An over-the-counter derivative, such as a forward contract or a swap, exposes the derivative holder to the risk that the counterparty may default.

Question #42 of 60

Question ID: 415720

Credit derivatives are *least accurately* characterized as:

- ✗ **A) contingent claims.**
- ✓ **B)** forward commitments.
- ✗ **C)** insurance.

Explanation

Credit derivatives are contingent claims and not forward commitments because their payoff depends on a future event taking place. Credit derivatives are essentially insurance against a credit event.

Question #43 of 60

Question ID: 415813

A similarity of margin accounts for both equities and futures is that for both:

✗ **A) interest is charged on the margin loan balance.**

✗ **B)** the value of the security is the collateral for the loan.

✓ **C)** additional payment is required if margin falls below the maintenance margin.

Explanation

Both futures accounts and equity margin accounts have minimum margin requirements that, if violated, require the deposit of additional funds. There is no loan in a futures account; the margin deposit is a performance guarantee. The seller does not receive the margin deposit in futures trades. The seller must also deposit margin in order to open a position.

Question #44 of 60

Question ID: 415723

A standardized and exchange-traded agreement to buy or sell a particular asset on a specific date is *best* described as a:

✗ **A) swap.**

✓ **B)** futures contract.

✗ **C)** forward contract.

Explanation

Futures contracts are standardized forward contracts that trade on organized exchanges. Other types of forward contracts, as well as swaps, are custom instruments that are generally not exchange-traded.

Question #45 of 60

Question ID: 415708

Which of the following statements regarding exchange-traded derivatives is NOT correct? Exchange-traded derivatives:

✓ **A) are illiquid.**

✗ **B)** often trade in a physical location.

✗ **C)** are standardized contracts.

Explanation

Derivatives that trade on exchanges have good liquidity in most cases. They have the other characteristics listed.

Question #46 of 60

Question ID: 415822

In the trading of futures contracts, the role of the clearinghouse is to:

✗ **A) stabilize the market price fluctuations of the underlying commodity.**

✗ **B)** maintain private insurance that can be used to provide funds if a trader defaults.

✓ **C)** guarantee that all obligations by traders, as set forth in the contract, will be honored.

Explanation

The clearinghouse does not originate trades, it acts as the opposite party to all trades. In other words, it is the buyer to every seller and the seller to every buyer. This action guarantees that all obligations under the terms of the contract will be fulfilled.

Question #47 of 60

Question ID: 415941

Which of the following regarding a plain vanilla interest rate swap is *most* accurate?

✗ **A)** **The notional principal is returned at the end of the swap.**

✗ **B)** The notional principal is swapped.

✓ **C)** Only the net interest payments are made.

Explanation

The plain vanilla interest rate swap involves trading fixed interest rate payments for floating rate payments. Swaps are a zero sum game, what one party gains the other party loses. In interest rate swaps, only the *net* interest rate payments actually take place because the notional principal swapped is the same for both counterparties and in the same currency units, there is no need to actually exchange the cash.

Question #48 of 60

Question ID: 415721

In a credit default swap (CDS), the buyer of credit protection:

✗ **A)** **exchanges the return on a bond for a fixed or floating rate return.**

✗ **B)** issues a security that is paid using the cash flows from an underlying bond.

✓ **C)** makes a series of payments to a credit protection seller.

Explanation

In a credit default swap (CDS), the buyer of credit protection makes a series of payments to a credit protection seller. The credit protection seller promises to make a fixed payment to the buyer if an underlying bond or loan experiences a credit event, such as a default. In a total return swap, the buyer of credit protection exchanges the return on a bond for a fixed or floating rate return. A security that is paid using the cash flows from an underlying bond is known as a credit-linked note.

Question #49 of 60

Question ID: 415743

The short in a forward contract:

✗ **A)** **has the right to deliver the asset upon expiration of the contract.**

✓ **B)** is obligated to deliver the asset upon expiration of the contract.

✗ **C)** is obligated to deliver the asset anytime prior to expiration of the contract.

Explanation

The short in a forward contract is obligated to deliver the asset (in a deliverable contract) on (or close to) the expiration date.

Question #50 of 60

Question ID: 415952

Which of the following statements regarding plain-vanilla interest rate swaps is *least* accurate?

✓ **A)** **In a swap contract, the counterparties usually swap the notional principal.**

✗ **B)** The time frame covered by the swap is called the tenor of the swap.

✗ **C)** The settlement dates are when the interest payments are to be made.

Explanation

The notional principal is generally *not* swapped, as it is usually the same for both parties in the swap deal.

Question #51 of 60

Question ID: 415724

Derivatives are often criticized by investors with limited knowledge of complex financial securities. A common criticism of derivatives is that they:

✗ **A)** **increase investor transactions costs.**

✗ **B)** shift risk among market participants.

✓ **C)** can be likened to gambling.

Explanation

Derivatives are often likened to gambling due to the high leverage involved in the payoffs. One of the benefits of derivatives is that they reduce transactions costs. Another benefit of derivatives is that they allow risk to be managed and shifted among market participants.

Question #52 of 60

Question ID: 415857

An American option is:

✗ **A)** **exercised only at expiration.**

✓ **B)** exercisable at any time up to its expiration date.

✗ **C)** an option on a U.S. stock or bond.

Explanation

There is no geographical significance given to American (style) options. It simply refers to the fact that they can be exercised at any time, up to and including the expiration date. European-style options can be exercised only on their expiration dates.

Question #53 of 60

Question ID: 415729

All of the following are benefits of derivatives markets EXCEPT:

✗ **A)** **transactions costs are usually smaller in derivatives markets, than for similar trades in the underlying asset.**

✗ **B)** derivatives allow the shifting of risk to those who can most efficiently bear it.

✓ **C)** derivatives markets help keep interest rates down.

Explanation

The existence of derivatives markets does not affect the level of interest rates. The other statements are true.

Question #54 of 60
Question ID: 415719

Which of the following statements regarding a forward commitment is NOT correct? A forward commitment:

✗ **A)** **can involve a stock index.**

✗ **B)** is a contractual promise.

✓ **C)** is not legally binding.

Explanation

A forward commitment is a legally binding promise to perform some action in the future and can involve a stock index or portfolio.

Question #55 of 60
Question ID: 415739

The process of arbitrage does all of the following EXCEPT:

✓ **A)** **insure that risk-adjusted expected returns are equal.**

✗ **B)** produce *riskless* profits.

✗ **C)** promote pricing efficiency.

Explanation

Arbitrage does not insure that the risk-adjusted expected returns to two risky assets will be equal. Arbitrage is based on risk-free portfolios and promotes efficient pricing of assets. When an arbitrage opportunity is presented by a mispricing of assets, the increased supply of the 'overpriced' asset and the increased demand for the 'underpriced' asset by arbitrageurs, will move the prices toward equality and act to correct the mispricing.

Question #56 of 60
Question ID: 415713

Which of the following definitions involving derivatives is *least* accurate?

✓ **A)** **A call option gives the owner the right to sell the underlying good at a specific price for a specified time period.**

✗ **B)** An arbitrage opportunity is the chance to make a riskless profit with no investment.

✗ **C)** An option writer is the seller of an option.

Explanation

A call option gives the owner the right to *buy* the underlying good at a specific price for a specified time period.

Question #57 of 60
Question ID: 415712

Which of the following is *most likely* an exchange-traded derivative?

✓ **A)** **Equity index futures contract.**

✗ **B)** Currency forward contract.

✗ **C)** Bond option.

Explanation

Futures are exchange-traded derivatives. Forward contracts and swaps are over-the-counter derivatives. Bond options are traded almost entirely in the over-the-counter market.

Question #58 of 60

Question ID: 460708

Which of the following statements about options is *most accurate*?

✓ **A) The holder of a put option has the right to sell to the writer of the option.**

✗ **B)** The holder of a call option has the obligation to sell to the option writer if the stock's price rises above the strike price.

✗ **C)** The writer of a put option has the obligation to sell the asset to the holder of the put option.

Explanation

The holder of a put option has the right to sell to the writer of the option. The writer of the put option has the obligation to buy, and the holder of the call option has the right, but not the obligation to buy.

Question #59 of 60

Question ID: 415715

Over-the- counter derivatives:

✗ **A) have good liquidity in the over-the-counter (OTC) market.**

✓ **B)** are customized contracts.

✗ **C)** are backed by the OTC Clearinghouse.

Explanation

OTC derivative contracts (securities) are customized and have poor liquidity. The contract is with a specific counterparty and there is default risk since there is no clearinghouse to guarantee performance.

Question #60 of 60

Question ID: 415709

A derivative security:

✗ **A) is like a callable bond.**

✗ **B)** has a value dependent on the shape of the yield curve.

✓ **C)** is one that is based on the value of another security.

Explanation

A derivative security is one that 'derives' its value from that of another security.