October 2011 Series #56 Supplemental Questions

1.
Which statement is **TRUE** regarding a firm's purchase and sales (trade) blotter?

I It must reflect all pending orders and executed orders
II It must reflect only executed orders
III It must be retained for 3 years
IV It must be retained for 6 years

a. I and III
b. I and IV
c. II and III
d. II and IV

2.
FINRA is conducting an investigation of an associated person in response to a complaint filed by a customer. Which statement is **TRUE** about an associated person who receives a notice to testify from FINRA?

a. That individual is prohibited from trading until he or she testifies under oath
b. That individual can only be required to testify outside of regular market trading hours
c. That individual can be compelled to testify at any time and location of FINRA's choosing
d. That individual cannot be compelled to testify until he or she receives a Wells Notice from FINRA

3.
All of the following disciplinary actions can be taken by an SRO against an associated person for rule violations **EXCEPT:**

a. monetary fine
b. expulsion
c. imprisonment
d. suspension

4.
Which statement is **TRUE** about a floor broker who receives an options order from a market maker?

a. The order must be refused
b. The order must be treated in the same manner as any other customer order
c. The floor broker must indicate the identity of the market maker to the trading crowd
d. The floor broker must cross the order silently and cannot display it to the market

5.
The exercise cut-off for listed equity options is:

a. 4:00 PM ET; 3:00 CT on the 3rd Friday of the expiration month
b. 4:30 PM ET; 3:30 CT on the 3rd Friday of the expiration month
c. 5:00 PM ET; 4:00 CT on the 3rd Friday of the expiration month
d. 5:30 PM ET; 4:30 CT on the 3rd Friday of the expiration month

6.
A “prime broker” would provide all of the following services **EXCEPT:**

a. Providing AML procedures to insure compliance with SRO rules
b. Financing of securities positions taken
c. Providing stock loans to clients that wish to take short positions
d. Maintaining custody of securities positions taken

7.
An options trader buys 1 XYZ Nov 60 Call @ $4 and sells 1 XYZ Nov 65 Call @ $2 when the market price of XYZ stock is at $61. This position:

a. is uneconomic
b. has a maximum gain potential of $300
c. has a maximum loss potential of $300
d. will breakeven at $63 per share

8.
Which statement is **FALSE?**

a. American style options can be traded at any time
b. American style options can be exercised at any time
c. European style options can be traded at any time
d. European style options can be exercised at any time

9.
Under Rule 201 of Regulation SHO, the requirement that any short sale be made on an “up bid” will be imposed:

I if a stock drops by 5%
II if a stock drops by 10%
III for the balance of that trading day
IV for the balance of that trading day and the entire next trading day

a. I and III
b. I and IV
c. II and III
d. II and IV

10.
Warrants can:

a. receive dividends
b. be perpetual
c. vote for the Board of Directors of the company
d. receive pre-emptive rights

11.
Selling short a stock without first locating the shares to be borrowed and determining that they can be delivered by settlement is a prohibited practice known as:

a. shorting against the box
b. naked short selling
c. trading away
d. shredding the market

12.
A trade of 225 shares is a:

a. round lot
b. odd lot
c. mixed lot
d. block lot

13.
ISO orders are:

I market orders
II limit orders
III executable in the market where received at an inferior price to that published by another market center
IV not executable in the market where received at an inferior price to that published by another market center

a. I and III
b. I and IV
c. II and III
d. II and IV

14.
The Investment Company Act of 1940 applies to all of the following **EXCEPT:**

a. ETFs
b. Mutual Funds
c. REITs
d. UITs

15.
A trade of 75 shares is a:

a. round lot
b. odd lot
c. mixed lot
d. block lot

Explanations

1. The best answer is **d.** The Purchase and Sales Blotter only reflects completed trades. It does not reflect orders that are pending. It is one of the 3 primary blotters that must be retained for 6 years. The other two primary blotters are the Cash Receipts and Disbursements Blotter and the Securities Receive and Deliver Blotter.

2. The best answer is **c.** FINRA has the right, in an investigation, to compel any member firm or associated person to produce documents, give testimony, take an oath, etc. During an investigation, an individual can still trade, because there is no presumption of guilt. If FINRA believes that there is sufficient evidence to take action against a firm or individual, it gives a "Wells Notice" stating that it will be commencing legal action.

3. The best answer is **c.** For rule violations, each SRO has the power to censure, suspend, expel, fine, and strip the licenses from an associated person. Each SRO does not have the power to imprison an individual for rule violations. Note, however, that the SRO can refer a case to the Department of Justice, which can sue in Federal court - and a court can put an individual in prison, if that is the penalty under law.

4. The best answer is **c.** Under CBOE rules, the floor broker acts as an agent for his or her customers, finding the best market price by contacting other floor brokers, the OBO and market makers in that option. A floor broker can take an order from a market maker to be filled - but the floor broker must announce, by open outcry, the identity of the market maker for whom the order is being filled.

5. The best answer is **d.** The trading cut-off for listed stock options is 4:00 PM ET; 3:00 PM CT on the 3rd Friday of the month. This is the same as the close of the equity trading markets. However, an exercise does not go through the trading floor. Rather, it is submitted directly to the OCC - and the OCC accepts exercise notices until 5:30 PM ET; 4:30 PM CT on that day.

6. The best answer is **a.** Prime brokerage is a service offered by the large trading firms mainly to hedge fund clients. The hedge fund might use Goldman Sachs as its "prime broker." Goldman agrees that the hedge fund can route its trades to any executing broker that it wishes (they don't all go through Goldman); but Goldman, as the prime broker, settles all the trades, maintains custody of the positions and provides financing for the positions. The hedge fund wishes to spread its trades across many executing brokers to disguise its trading strategies, and also as a "quid pro quo" for market information that it obtains from these executing firms (who earn the commissions on these trades, known as "directed brokerage"). Also, a large part of prime brokerage is stock lending to hedge funds that wish to sell short (this is a big hedge fund strategy) and the prime broker handles this. The prime broker does not provide AML (Anti-Money Laundering) services to the member firms for which it clears. Each member firm is responsible for its own AML program.

7. The best answer is **b.** This is a long call spread. The positions taken are:

Buy 1 XYZ Nov 60 Call @ $4
Sell 1 XYZ Nov 65 Call @ $2

$2 Debit

This strategy is profitable in a rising market. In a rising market, the stock can be purchased at $60 by exercising the long call. If the market continues to rise above $65, the short 65 call is exercised, forcing the stock to be sold at $65. The maximum gain is $5, offset by the $2 debit paid, = 3 points or $300. If the market falls below $60, both calls expire worthless and the debit of $2 ($200 is lost). Breakeven occurs a $60 + $2 Debit = $62.

8. The best answer is **d.** Stock options are “American Style.” They can be traded anytime and can be exercised anytime. In contrast, almost all index options are “European Style.” A European style option can be traded anytime, but it cannot be exercised until expiration.

9. The best answer is **d.** Do not confuse Regulation SHO Rule 201 with the single stock circuit breaker rule. Under Regulation SHO, if a stock falls by 10% or more in a trading day, it can only be sold short on an upbid for the remainder of that day and the entire next day. Under the single stock circuit breaker rule, if any single stock rises or falls by 10% or more within a 5 minute window of time in its primary market, the exchange will stop trading of that stock for 5 minutes; and the CBOE will stop trading of related options as well.

10. The best answer is **b.** Warrants are long-term options that are typically attached to “difficult to sell” securities. They are often used by companies emerging from bankruptcy or that are in financial distress, to raise capital. For example, to attract investors to a preferred stock offering, the “troubled” company might attach a perpetual warrant to buy its stock at $10, when the common stock price is at $3. The warrant has no inherent value unless the common stock price rises above $10. Warrants do not receive dividends; they do not vote; and they do not have preemptive rights.

11. The best answer is **b.** “Naked short selling” is a now-prohibited practice that was often used by aggressive hedge funds, and it was the practice that led the SEC to write Regulation SHO. Before this rule, large hedge fund investors could “short, short, short” a stock, driving the price down and never borrow the shares for delivery on settlement. These “fails to deliver” would ultimately be cured by the hedge fund buying back that stock at the now-cheaper market price. However, when a firm fails to deliver, this can lead to a cascading effect of fails from one firm to another. The SEC basically stopped this by requiring that before a short sale is permitted, the location of the shares to be borrowed must be ascertained and it must be determined that the shares can be delivered on settlement. Furthermore, this must be documented by the member firm.

12. The best answer is **c.** A round lot trade is 100 shares or a trade in multiples of 100. An odd lot trade is a trade of less than 100 shares. A mixed lot trade is one that has both a round lot component and an odd lot component.

13. The best answer is **c.** An "ISO" order is an "Intermarket Sweep Order." It is a large institutional limit order that is broken apart and routed by the institution to multiple market venues in an attempt to "sweep" the top of each market's display book at the same time to get a fill at the best price. Such an order places the "best execution" requirement in the hands of the institution, not the executing market. ISOs are exempt from the trade-through rule (Rule 611 of Regulation NMS), because of this. ISO orders must be noted as such at order entry, so the regulators and the marketplace know that they have no obligation to re-route the order to the best market, if that market is not posting the best price.

14. The best answer is **c.** REITs are Real Estate Investment Trusts - they invest in real estate, not securities, so they are not investment companies. The defined investment companies under the Investment Company Act of 1940 are:

Face Amount Certificate Companies;
Unit investment Trusts: and
Management Companies.

A management company can either be "open-end" (a mutual fund, which is open to new investment); or "closed-end" (an exchange traded fund where new investment is not made - rather, the shares are listed and trade like any other stock).

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