Series #56
Final 3

1.
All of the following statements about warrants are true **EXCEPT:**

a. Warrants have a longer term than rights
b. Warrants are issued to make corporate securities offerings more attractive to investors
c. Warrants give the holder a perpetual interest in the issuer's underlying common stock
d. Warrants trade separately from the stock of the company

2.
Common stockholders have which of the following "rights"?

I Right to vote for the Board of Directors
II Right to vote for the annual dividend rate
III Preemptive right
IV Rights to corporate assets upon dissolution

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

3.
An ADR is a:

a. U.S. security held in U.S. branches of foreign banks
b. foreign security held in foreign branches of U.S. banks
c. negotiable certificate denominated in a foreign currency
d. negotiable certificate denominated in U.S. currency

4.
Preferred stock has all of the following features as compared to common stock **EXCEPT**:

a. fixed rate of return
b. fixed maturity
c. priority claim to dividends declared
d. priority claim to assets upon dissolution

5.
A customer holds 100 shares of ABC Corp. $100 par non-convertible preferred stock. If ABC declares and pays a 10% common stock dividend, then as of the payable date, the customer will now have:

a. 90 shares of ABC preferred stock
b. 100 shares of ABC preferred stock
c. 100 shares of ABC preferred stock and 10 shares of ABC common stock
d. 110 shares of ABC preferred stock

6.
Preferred stock valuation is based primarily upon:

a. future earnings expectations for the issuer
b. short term market interest rate levels
c. long term market interest rate levels
d. future dividend payment expectations for the issuer

7.
A Specialist (DMM) on the NYSE quotes ABC stock at:

\$40.00 - \$40.02
250 x 150

A customer places an order to sell 25,000 shares of ABC stock at the market. The Specialist (DMM):

a. is not required to fill the order
b. will put the order on his book
c. will fill the order in full for 25,000 shares
d. will fill the order for 15,000 shares and place the remaining unfilled portion of the order for 10,000 shares on his book

8.
Regulation NMS applies to:

I NYSE listed issues
II AMEX listed issues
III NASDAQ listed issues

a. I only
b. I and II
c. II and III
d. I, II, III

9.
Regulation SHO is a body of rules covering:

a. shorting against the box in an arbitrage account
b. short sales of equities traded on an exchange or over-the-counter
c. short term capital gains treatment on securities transactions
d. shorting of naked options by retail customers

10.
The Third Market trades:

a. listed securities on an exchange floor
b. unlisted securities on an exchange floor
c. listed securities over-the-counter
d. securities of companies based in Third World countries

11.
Rule 605 of Regulation NMS requires:

a. each market center to prepare monthly electronic reports about its quality of executions and effective spreads
b. each broker-dealer to prepare quarterly reports on its routing of non-directed orders, including the 10 largest venues where orders were routed
c. market makers in OTC stocks to display any customer limit orders that are better-priced than the dealer's own quote
d. any order execution facility to execute the order at the NBBO, even if that execution facility is posting an inferior quote

12.
Rule 606 of Regulation NMS requires:

a. each market center to prepare monthly electronic reports about its quality of executions and effective spreads
b. each broker-dealer to prepare quarterly reports on its routing of non-directed orders, including the 10 largest venues where orders were routed
c. market makers in OTC stocks to display any customer limit orders that are better-priced than the dealer's own quote
d. any order execution facility to execute the order at the NBBO, even if that execution facility is posting an inferior quote

13.
A customer has sold short 100 shares of XYZ stock at $90 per share. The stock has declined to $78.75, and the customer now sells an XYZ Jul 80 Put @ $5. The customer has created the synthetic equivalent of a:

a. long call
b. short call
c. long put
d. short put

14.
Prior to the opening of the options exchange, investor wishes to place an order to buy an option contract at a premium that is lower than the previous day's close. The order type to be placed is a(n):

a. At the open order
b. Limit order
c. Stop order
d. Not Held order

15.
On the same day in a margin account, a customer buys 200 shares of ABC stock at $48 per share, and sells 5 ABC Jan 50 Calls @ $1.50. The customer will breakeven at:

a. 50.50
b. 48.50
c. 46.50
d. 44.25

16.
Which two of the following create a collar on ABC stock, which is currently trading at $42 per share?

I Buy 1 ABC Jan 40 Call
II Buy 1 ABC Jan 40 Put
III Sell I ABC Jan 50 Call
IV Sell 1 ABC Jan 50 Put

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

17.
The synthetic equivalent of a short put is:

a. long stock / long put
b. long stock / short call
c. short stock / long call
d. short stock / short put

18.
All of the following are income strategies **EXCEPT:**

a. Long stock / Short call
b. Short stock / Short put
c. Short call / Short put
d. Long call / Long put

19.
A registered representative is bearish on ABC stock and buys 10 ABC Jul 60 Put contracts. The representative then contacts each of his largest customers to explain his bearish sentiment and recommend that they buy put options on ABC. Which statement is true?

a. There is no rules violation based upon the actions of the representative
b. This is a potential insider trading violation
c. This is a potential front running violation
d. This is a potential free riding violation

20.
Which two of the following are neutral options strategies?

I Short Straddle
II Long Straddle
III Butterfly Spread
IV Short Call Spread

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

21.
A customer that wishes to sell 1 ABC Jan 60 Call @ $5 in a cash account is permitted to do so if:

a. 100 shares of ABC stock are held long in the customer account
b. the customer provides a bank guarantee letter for $6,000
c. the customer is long an ABC Jan 50 Call in the account
d. any of the above

22.
Which statement is true regarding index options?

a. Exercise settlement results in a delivery of the securities in the index
b. The regular trading session ends at 4:15 PM ET, 3:15 PM CT
c. Exercise settlement occurs in 3 business days
d. Most index options are issued in American style

23.
An accommodation liquidation order is a:

a. market order
b. limit order
c. stop order
d. market if touched order

24.
FLEX options:

a. are issued by the Options Clearing Corporation
b. are issued by the writer in an OTC transaction
c. are not guaranteed by the Options Clearing Corporation
d. are not permitted to be traded after issuance

25.
Options confirmations must include the:

a. exercise price per share
b. aggregate exercise price
c. exercise cut-off date and time
d. exercise style

26.
All of the following can be specified by a customer who wishes to write a PHLX FLEX option **EXCEPT** the contract:

a. size
b. expiration
c. strike price
d. premium

27.
Once a customer establishes an options position, the OCC reserves the right to change all of the following terms of the contract **EXCEPT:**

a. Number of shares covered by the contract
b. Number of contracts covering 100 shares each
c. Exercise price of the contract
d. Exercise style of the contract

28.
A registered representative in the branch receives an order from an institutional customer to sell 500,000 shares of ABCD stock at the market. When the member firm's block trading desk receives the order, the trader checks the firm's proprietary position and determines that the member firm is long 200,000 shares of ABC in inventory. The trader is concerned that execution of the customer sell order will cause the firm to have an inventory loss on its ABCD stock position and wants to buy 2,000 put option contracts on ABCD stock. The member firm may buy the put options:

a. prior to executing the customer order to sell
b. at the same time as the customer order to sell is filled
c. when the execution report of the customer sell order has been published
d. under no circumstances

29.
If the exchange that trades the stock underlying an options contract stops trading that stock, then all of the following are true **EXCEPT:**

a. the option contract will stop trading
b. the option contract can be exercised
c. existing options orders to buy or sell can be filled
d. existing orders to buy or sell can be canceled

30.
Which positions have unlimited loss potential?

I Short uncovered call
II Short uncovered put
III Short stock / Long call
IV Short stock / Short put

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

31.
Which of the following is a function of the OCC?

a. Trading listed options contracts in a fair and orderly manner
b. Guaranteeing performance upon the exercise of a short option contract
c. Allocating an exercise notice to an individual customer that is short that contract
d. Establishing the premium to be paid from the buyer to the seller of the contract

32.
The OCC assigns exercise notices on a:

a. random basis
b. FIFO basis
c. either a random or FIFO basis
d. any method that is fair and reasonable

Use the following information to answer the next 3 questions:

On the same day a customer buys 100 shares of ABC stock at $40 and sells 1 ABC Jan 40 Call @ $4 and sells 1 ABC Jan 40 Put @ $2.

33.
This strategy is known as a:

a. covered straddle
b. covered call writer
c. ratio write
d. butterfly spread

34.
The maximum potential gain is:

a. $600
b. $3400
c. $7400
d. Unlimited

35.
The maximum potential loss is:

a. $600
b. $3400
c. $7400
d. Unlimited

36.
Bear put spreads are profitable if:

I Both puts expire
II Both puts are exercised
III The spread between the premiums widens
IV The spread between the premiums narrows

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

37.
Which of the following are bullish options strategies on ABC stock, currently trading at $60 per share?

I Buy ABC 60 Calls
II Sell ABC 60 Puts
III Buy ABC 60 Calls and Sell ABC 70 Calls
IV Buy ABC 70 Puts and Sell ABC 60 Puts

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

38.
A customer who is short puts, and who buys the underlying stock in an attempt to keep the puts from moving "in the money" as expiration approaches, is engaging in the illegal practice of:

a. hedging
b. capping
c. supporting
d. pegging

39.
Floor Brokers on the CBOE are allowed to accept which of the following orders?

I Limit
II Stop
III Spread
IV Straddle

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

40.
The initial strike price of an option contract is determined by the:

a. Options Clearing Corporation
b. Securities and Exchange Commission
c. market value of the underlying stock
d. length of time until expiration of the contract

41.
If a market is deemed to be "FAST" by 2 Floor Officials, entry of which of the following orders may be restricted?

I Market
II Market If Touched
III Limit
IV Stop

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

42.
If a put is exercised just prior to the ex-dividend date for the underlying stock, which statements are true?

I The holder of the put receives the dividend
II The holder of the put does not receive the dividend
III The writer of the put receives the dividend
IV The writer of the put does not receive the dividend

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

43.
Accommodation liquidation orders are placed at an aggregate premium of:

a. $1 per contract
b. $10 per contract
c. $100 per contract
d. $1000 per contract

44.
A customer enters an order to buy 10 XYZ Jan 50 Calls @ $4. A trade occurs at that price, but the customer's order is not executed. This would occur because:

I There were buy limit orders at the same price for other customers ahead of this order
II There were buy limit orders at the same price for other member firms ahead of this order
III There were spread orders that required the purchase of the same option ahead of this order
IV There were buy limit orders at the same price for market makers ahead of this order

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

45.
Which of the following positions has unlimited loss potential?

a. Long ABC Stock / Long ABC Put
b. Long ABC Stock / Short ABC Call
c. Short ABC Stock / Long ABC Call
d. Short ABC Stock / Short ABC Put

46.
A customer wishes to participate in a tender offer for ABCD common stock. The customer may tender if he or she owns:

a. ABCD non-convertible bonds
b. ABCD convertible bonds
c. ABCD call options that have been exercised
d. ABCD preferred stock

47.
Transactions that seek to take illegal funds and turn them into legitimate circulation are known as:

a. wash sales
b. fraudulent conversion
c. money laundering
d. blue skying

48.
Which of the following events would require a report under SEC Rule 17f-1 within 1 business day of discovery?

a. The receipt of certificates found to be counterfeit
b. Securities discovered to be missing as the result of a routine securities count
c. Certificates discovered to be missing after a natural disaster damages the offices of the firm
d. The receipt of bearer bonds that are missing upcoming interest coupons

49.
An order ticket to sell may be marked "long" in all of the following circumstances **EXCEPT** the customer:

a. is long a call on that stock that has been exercised
b. is short a put on that stock that has been exercised
c. holds fully-paid convertible preferred stock of that issuer and has given instructions to convert
d. holds fully paid warrants to buy the underlying stock in custody of the broker-dealer

50.
Which statements are true?

I All XYX Calls are an options class
II All XYX Jul 50 Calls are an options class
III All XYX Calls are an options series
IV All XYX Jul 50 Calls are an options series

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

51.
ABC Corporation's share price has declined from $30 to $10, prompting the issuer to declare a 1:3 reverse stock split. As of the "ex" date, the holder of 1 ABC Jan 10 Call will have:

a. 1 ABC Jan 10 Call covering 100 shares
b. 3 ABC Jan 10 Calls covering 100 shares
c. 1 ABC Jan 30 Call covering 33.33 shares
d. 3 ABC Jan 30 Calls covering 33.33 shares

52.
The CBOE may halt trading in a listed option contract for which of the following reasons?

I Trading in the underlying security has been halted in the security's primary market
II The opening of trading in the underlying security has been delayed because of unusual market conditions
III Other unusual conditions or circumstances are present

a. I only
b. I and II
c. II and III
d. I, II, III

53.
All of the following positions can be held in a portfolio margin account **EXCEPT:**

a. listed options
b. warrants
c. index options
d. debentures

54.
A customer that has agreed to submit a dispute to mediation:

a. is permitted to withdraw from the mediation process without consent of the other party or the mediator
b. can only withdraw from the mediation process with the consent of the mediator
c. can only withdraw from the mediation process with the consent of the other party
d. can only withdraw from the mediation process with the consent of FINRA

55.
Which of the following best describes "structuring"?

a. Depositing or withdrawing bond certificates to or from an account in amounts just below Federal reporting requirements
b. Depositing or withdrawing stock certificates to or from an account in amounts just below Federal reporting requirements
c. Depositing or withdrawing cash to or from an account in amounts just below Federal reporting requirements
d. Depositing or withdrawing bank checks to or from an account in amounts just below Federal reporting requirements

56.
A market maker on the CBOE is inundated with a flood of orders because of a major news announcement about the issuer in which he makes a market. The market maker cannot keep up with the order flow and declares a "FAST" market. This action is:

a. permitted because of the influx of orders
b. permitted if the primary market for the stock also declares a "FAST" market
c. prohibited because the market maker does not have the authority to declare a "FAST" market
d. prohibited because market makers must have the ability to keep up with all orders they receive

57.
The synthetic equivalent of a short call is:

a. long stock / long put
b. long stock / short call
c. short stock / long call
d. short stock / short put

58.
In determining if there is a violation of position limits, short calls would be aggregated with:

I Long Calls
II Long Puts
III Short Puts

a. I only
b. II only
c. III only
d. I, II, III

59.
Common stockholders and preferred stockholders **BOTH** have:

a. voting right
b. preemptive rights
c. dividend rights
d. subscription rights

60.
A company decides to split its stock 5:4. Prior to the ex-date, the stock is trading at $50 per share. The holder of 100 shares, as of the ex-date, will have:

a. 120 shares valued at $40 per share
b. 125 shares valued at $40 per share
c. 120 shares valued at $60 per share
d. 125 shares valued at $60 per share

61.
Gamma will be greatest for an option that is:

a. in the money
b. out the money
c. at the money
d. close to expiration

62.
Which of the following are SROs?

I FINRA
II SIPC
III SIFMA
IV CBOE

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

63.
A NASDAQ listed issuer places an order to buy its common stock within 1/2 hour of the close of the market. Which statement is true regarding the handling of this order?

a. This order can be accepted with no further action necessary
b. This order cannot be accepted
c. This order can only be accepted with the permission of FINRA
d. This order can only be accepted if the issuer is informed that this transaction may be viewed as "manipulative"

64.
All of the following are responsibilities of NASDAQ's MarketWatch department **EXCEPT:**

a. Monitoring NASDAQ securities for unusual price and volume activity
b. Monitoring NASDAQ market makers for timeliness and quality of trade executions
c. Making decisions on reports of clearly erroneous trades
d. Assessing corporate news announcements for potential market impact and implementing a trading halt, if needed

65.
If the inside spread is 4 cents, the minimum increment necessary to qualify for price improvement is:

a. 1 cent
b. 2 cents
c. 3 cents
d. 4 cents

66.
A block under Regulation NMS is defined as a trade of:

I 1,000 shares or more
II 10,000 shares or more
III $100,000 or more
IV $200,000 or more

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

67.
The "trade-through" rule of Regulation NMS applies during the hours of:

a. 9:30 AM - 4:00 PM ET
b. 7:00 AM - 7:00 PM ET
c. 8:00 AM - 8:00 PM ET
d. 7:00 AM - 8:00 PM ET

68.
Which of the following is **NOT** defined as an ATS (Alternative Trading System)?

a. Electronic Communications Network
b. Dark Pool
c. Member Firm Internal Crossing Network
d. Electronic Securities Exchange

69.
Which of the following is **NOT** required to be on an order ticket to purchase a security at a limit price?

a. Whether the trade was solicited or unsolicited
b. If the customer does not wish the order to be adjusted on ex date for a cash dividend, the marking "DNR"
c. Whether the firm acted in an agency or principal capacity in the transaction
d. The name or account number of the customer

70.
Regulation NMS requires which of the following for market participants that wish to trade NMS securities?

I Market participants are prohibited from entering quotes that will lock or cross the market
II Market participants must be able to access each other's quotes and trade against them within 1-second
III Market venues are prohibited from charging access fees
IV Market venues can require users to execute trades on that venue's proprietary system

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

71.
Broker-dealers which have payment for order flow arrangements with market makers must disclose these arrangements in which of the following SEC reports?

a. Form 211
b. Rule 605
c. Form B/D
d. Rule 606

72.
If a market maker attempts to lock in the market during normal market hours, Single Book will:

a. display the order in Level II
b. place the order in MPID "NSDQ" at the locking price
c. return the order to the market maker
d. route the order for execution at the locking price

73.
A customer that is long 10 ABCD convertible bonds, convertible at $50 each, places an order to sell 200 shares of ABCD stock. The customer tenders the bonds for conversion, but the shares will not arrive at the transfer agent until after settlement. Under SEC rules:

I the sell order ticket is marked "long"
II the sell order ticket is marked "short"
III if the shares are not received within 13 business days, they must be bought in
IV if the shares are not received within 35 calendar days, they must be bought in

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

74.
During the 1-day restricted period prior to the effective date for an additional issue offering, a trader at a syndicate member places a bid and purchases the subject security. The SEC will overlook this Rule 101 violation if all of the following are true **EXCEPT:**

a. the firm resigns from the syndicate
b. the purchase was inadvertent
c. the amount purchased totaled less than 2% of the security's average daily trading volume
d. the firm has in place protective procedures designed to achieve compliance with Rule 101

78.
A customer is long 500 shares of ABC stock in a cash account and is short 300 shares of ABC stock in a margin account at the same firm. The customer wishes to sell the 500 shares in the cash account. To do this, the order ticket must be marked:

a. Sell 500 ABC Long
b. Sell 500 ABC Short
c. Sell 300 ABC Long/Sell 200 ABC Short
d. Sell 200 ABC Long/Sell 300 ABC Short

79.
The Limit Order Protection Rule applies to:

I Listed securities traded on an exchange floor
II Listed securities traded over-the-counter
III NASDAQ Global Market securities
IV NASDAQ Capital Market securities

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

80.
A member firm is about to issue a research report about ABCD Corporation, a NASDAQ listed issuer. The member firm's proprietary trading desk may:

I increase its inventory position in ABCD stock in anticipation of heightened investor interest if the report is favorable
II decrease its inventory position in ABCD stock in anticipation of lowered investor interest if the report is unfavorable
III increase its inventory position in ABCD stock in response to heightened unsolicited order flow for ABCD stock
IV decrease its inventory position in ABCD stock in response to lowered unsolicited order flow for ABCD stock

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

81.
The Manning Rule covers:

a. market orders
b. limit orders
c. stop orders
d. GTC orders

82.
A market maker in a Global Market stock would **NOT** be allowed to do which of the following over the telephone?

a. Inform another dealer that its market size in the subject security is larger than that displayed on NASDAQ
b. Ask another dealer to tighten its bid-ask spread in the subject security
c. Honor a bid for the subject security from which another dealer has just backed away
d. Negotiate a transaction price for the subject security between the current best bid and offer

83.
Which of the following would be considered to be a manipulative practice?

a. Executing transactions for the purpose of inducing customers to purchase a security
b. Refusing to honor customer instructions regarding the handling of that customer's account
c. Executing transactions to buy for the member firm's trading account while holding customer orders to buy at the same price
d. Refusing to trade a security for a customer at the quoted price

84.
Under Regulation SHO, a "threshold security" is one that:

a. cannot be sold short under any circumstances but long sales are permitted
b. can only be sold short at a price that is $.01 higher than the preceding trade
c. if sold short and not delivered within 13 settlement days of the trade, buy-in is required
d. if sold short on a downtick, must be immediately bought-in on an up-tick

85.
Under the "best execution" rule, the factors that are considered include the:

I character of the market for the security
II size and type of transaction
III price and volatility of the security
IV number of markets checked

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

86.
In order to receive a dividend distribution, the last time for the holder of a call option to exercise is:

a. at least 5 business days prior to the ex-date
b. just prior to the ex-date
c. just prior to the record date
d. just after the ex-date

87.
When comparing statutory versus cumulative voting methods, which statement is true?

a. Minority shareholders have the same voting effectiveness with both methods
b. Minority shareholders have greater voting effectiveness with cumulative voting
c. Minority shareholders have greater voting effectiveness with statutory voting
d. Minority shareholders have limited voting powers under the statutory method and full voting powers under the cumulative method

88.
A customer owns 1 ABC Jul 30 Call. ABC goes ex dividend $1.00. As of the morning of the ex-date, the contract will cover:

a. 100 shares at 29
b. 100 shares at 30
c. 101 shares at 29
d. 101 shares at 30

89.
Which statements are true about shareholder rights?

I Common shareholders have preemptive rights
II Preferred shareholders have preemptive rights
III Common shareholders have voting rights
IV Preferred shareholders have voting rights

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

90.
Which one of the following customer actions could be an indicator of money laundering?

a. Selling a security that has depreciated after holding it for one week and then buying back the position more than 30 days later
b. Selling a security that has depreciated after holding the position for 1 week and then directing that the sale proceeds be wired to an overseas account
c. Buying back a security that has depreciated after shorting it for 1 week and using the proceeds to short another position
d. Selling stock short and 30 days later selling a put option against the stock position

91.
An ETN offers an investor all of the following benefits **EXCEPT:**

a. lack of liquidity risk
b. lack of credit risk
c. tax-efficiency
d. access to returns of foreign investments

92.
All of the following statements are **TRUE** about ETNs **EXCEPT:**

a. ETNs can be traded in the market like any other stock
b. ETNs offer an investment return tied to a benchmark index
c. ETNs are an equity security
d. ETNs are tax-advantaged

93.
Failure to honor a stated quote is a violation known as:

a. backing away
b. selling away
c. quoting away
d. trading away

94.
The term "DNR" would apply to:

I Buy Limit orders
II Buy Stop orders
III Sell Limit orders
IV Sell Stop orders

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

95.
All of the following must be reported to SIC **EXCEPT:**

a. lost securities
b. stolen securities
c. receipt of counterfeit securities
d. receipt of a bearer bond missing coupons

96.
A customer order to sell can be marked "Long" in all of the following situations **EXCEPT:**

a. the securities are held in street name by the broker-dealer
b. the securities are held in a customer safe deposit box and the customer will deliver on settlement
c. the securities are held registered in the name of the customer in book entry form by DTCC
d. the securities were previously purchased by that customer at the same broker-dealer that received the customer sell order

97.
Which statements are true about the use of mediation to settle disputes?

I The mediator is a neutral, impartial facilitator in the process
II The mediator has the authority to determine issues, make decisions, and resolve the matter
III Any party to the mediation can withdraw at any time prior to the execution of a written settlement agreement
IV Once the parties agree to submit the dispute to mediation, any decision of the mediator is final and non-appealable

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

98.
A foreign stock traded here in the U.S. as an ADR has been halted from trading by NASDAQ, but it is still trading in the foreign market. A member firm that receives a market order to buy that stock:

a. cannot execute the order
b. is permitted to execute the order
c. must route the order to the foreign market for execution
d. can only execute the order on an ATS

99.
A customer is short 100 shares of DEF 300% Leveraged ETF. If the minimum maintenance margin requirement is set at 30%, the margin requirement for this position will be:

a. 30%
b. 50%
c. 60%
d. 90%

100.
SEC Rule 10b-5-1:

a. is the "catch all" fraud rule that makes any deceptive or manipulative practice in connection with the sale of a security potentially fraudulent under the Securities Exchange Act of 1934
b. gives officers of publicly held companies a safe harbor from being charged with an insider trading violation if they establish a pre-arranged trading plan for that issuer's securities
c. prohibits the purchase or sale of an issuer's securities based on material nonpublic information in breach of duty of trust owed to the issuer or shareholders of that security
d. prohibits any person, in connection with a tender offer for securities, to bid for or purchase the security which is subject of the tender offer through any means other than via the offer

Series #56 - Final 3 Explanations

1. The best answer is **c.** Warrants are long term options to buy a company's shares at a fixed price. They are typically attached to debt and preferred stock offerings to make the securities more attractive to purchasers. This is accomplished because the warrant gives growth potential to these senior security holders if the common stock price should rise in the future. Warrants typically have a fixed life of 5 years or less and then expire. Companies can issue perpetual warrants, but rarely do so.

2. The best answer is **d.** Common shareholders do not set the dividend rate - this decision is made by the Board of Directors of the company. Common shareholders do have the right to vote for the Board of Directors; the pre-emptive right to any new common shares that the company may issue; and the right to remaining corporate assets upon dissolution.

3. The best answer is **b.** An American Depositary Receipt is a foreign security that is held in a foreign branch of a U.S. bank. The bank issues receipts against these shares, and the receipts are registered in the United States as securities and are listed and traded on U.S. stock exchanges. In this manner, the foreign corporation does not have to register its shares with the SEC in order to have trading take place in the U.S.

4. The best answer is **b.** Preferred stock does not have a stated maturity - it has an indefinite life. Preferred stock does have a stated dividend rate and priority claim to both dividends and corporate assets over common stock.

5. The best answer is **b.** Stock dividends paid to common shareholders have no impact on non-convertible preferred shareholders. This preferred shareholder has 100 shares; and gets no additional shares when the common stock dividend is paid. Common stockholders have a pre-emptive right; preferred stockholders do not.

6. The best answer is **c.** Preferred stock is a fixed income security with an "infinite life" since there is no maturity. The price of fixed income securities is determined by market interest rate levels. As market interest rates rise, preferred stock prices fall; as market interest rates fall, preferred stock prices rise. Since preferred stock is a long term investment, long term interest rate levels (not short term) determine market pricing.

7. The best answer is **c.** The Specialist/DMM is quoting the stock at $40.00 Bid with a size of 250 (good for 250 x 100 = 25,000 shares); and $40.02 Ask with a size of 150 (good for 150 x 100 = 15,000 shares). This customer is placing an order to sell 25,000 shares at the market. Since the Specialist has customers willing to buy 25,000 shares at the current Bid of $40.00, the order will be filled in full at the current Bid.

8. The best answer is **d.** The "NMS" securities under Regulation NMS (National Market System) are NYSE, AMEX and NASDAQ listed issues. OTCBB and Pink Sheet issues are not subject to Regulation NMS.

9. The best answer is **b.** Regulation SHO is a newer SEC rule intended to apply a uniform short sale rule to both exchange listed and OTC equity issues; and to stop the illegal practice of "naked" short selling (selling short a security without the intention to borrow and deliver the securities on settlement).

10. The best answer is **c.** The Third Market is OTC trading of exchange listed securities. Trading of listed securities on an exchange floor is the First Market. There is no formal name (yet) for trading of unlisted securities on an exchange floor, such as trading of NASDAQ or OTCBB issues by exchange Specialists under a UTP (Unlisted Trading Privilege) plan.

11. The best answer is **a.** Rule 605 of Regulation NMS requires market centers to make monthly electronic reports about the quality of execution in each stock traded, including how market orders of various sizes are executed relative to public quotes. The reports must also include information about effective spreads. In addition, market centers must provide reports on the extent to which they were able to "improve" execution prices for limit orders as compared to the public quote at that time. Do not confuse Rule 605 with Rule 606.

12. The best answer is **b.** Rule 606 requires member firms to prepare a quarterly report on the routing of their non-directed customer orders. The report, which is publicly available, details the percentage of customer orders that were "non-directed;" the identity of the 10 largest markets or market makers to whom non-directed orders were routed; and details the member firm's relationship with that market maker (for example, many larger retail member firms own their own market maker subsidiaries to whom they route orders); and any arrangement for payment for order flow or profit-sharing.

Rule 605 of Regulation NMS requires market centers to make monthly electronic reports about the quality of execution in each stock traded, including how market orders of various sizes are executed relative to public quotes. The reports must also include information about effective spreads. In addition, market centers must provide reports on the extent to which they were able to "improve" execution prices for limit orders as compared to the public quote at that time. Do not confuse Rule 606 with Rule 605.

13. The best answer is **b.** The short stock position gives the customer the upside characteristic of unlimited loss potential. On the downside, the customer has no loss potential because the short put will be exercised, forcing the customer to buy in the stock that was previously sold short. The customer will keep the premium on the short put, plus will have a gain on the stock position. Thus, the characteristics of "short stock/short put" are unlimited upside loss and limited downside gain. The option position that matches these characteristics is a naked short call.

14. The best answer is **b.** The orders that are placed **lower** than the current market are "OBLOSS" - Open Buy Limit orders and Open Sell Stop orders. Thus, to buy an option at a premium that is lower than the closing price, an open buy limit order would be placed. Conversely, the orders that are placed **higher** than the current market are "OSLOBS" - Open Sell Limits and Open Buy Stops. Thus, to buy at a price higher than the current market, an open buy stop order would be placed.

15. The best answer is **d.** The customer has bought 200 shares of ABC stock at $48 and has sold 5 ABC Jan 50 Calls @ $1.50 for a total collected premium of $7.50. If the market stays below $50, the calls will expire out the money and the customer keeps the $7.50 of collected premiums. If the market on the stock keeps dropping, the customer will lose on the 200 shares that were originally purchased at 48. The customer can afford to lose $750/200 shares = $3.75 per share and will still breakeven. Thus, in a falling market, the breakeven point is $48 - $3.75 = $44.25 per share. If the market continues to fall, the customer can lose a maximum of $44.25 x 200 shares = $8,850. On the other hand, if the market rises above 50, the 5 short calls will be exercised. The customer is covered on 2 of

the calls, and will deliver the stock purchased at 48 for the 50 strike price, for a 2 point gain per share x 200 shares = $400 gain. The customer has also collected $750 in premiums, for a total gain of $1,150. The customer is naked on the remaining 3 contracts to deliver at $50 per share. In a rising market, the customer can afford to lose the $1,150/300 shares = $3.83 per share and will still breakeven. Thus, the upside breakeven is $53.83. If the market continues to rise, the customer has unlimited loss potential on the 3 short naked call positions.

16. The best answer is **c.** When a customer places a "collar" on a stock position, he or she is "locking in" a sale price by buying a put at a strike price below the current market price of the stock (here the put is purchased with a $40 strike when the stock is trading at $42). To offset the cost of the put, a call is sold at a strike price above the current market price of the stock ($50, when the market price is at $42). If the stock's price rises above $50, the short call will be exercised, obligating the customer to deliver the shares at $50. Thus, the stock's price is now "collared" between $40 and $50.

17. The best answer is **b**. Assume a customer sells 1 ABC Jan 50 Put @ $5. If the market rises, the put expires and the gain is $5 points. If the market falls, the put is exercised, obligating the customer to buy the stock at $50. Since $5 was collected in premiums, the customer will breakeven if the stock falls to $45. If the stock continues to fall, the customer can lose all $45 per share. Compare this to a customer who:

Buys 100 Shares of ABC Stock @ $50
Sells 1 ABC Jan 50 Call @ $5

If the stock rises above $50, the short call is exercised. The stock that was purchased for $50 is delivered at $50. The customer makes the $5 point premium only. If the market falls, the short call expires. The customer paid $50 for the stock, offset by $5 in collected premiums, for a net cost of $45 per share. This is the breakeven point. If the market continues to fall, all $45 per share can be lost on the stock position.

Thus, this position (Long Stock / Short Call) is exactly the same as a Short Put.

18. The best answer is **d.** To get income against a stock position, the option must be sold so that a premium is collected. In Choice **d**, the option is purchased, not sold. A put is purchased against a long stock position to hedge the stock position against a downward market move. The cost of the protection is the premium paid to buy the put.

19. The best answer is **c.** The registered representative has positioned his personal account prior to recommending the same strategy to his customers. If the customers take the recommended action, it could give the registered representative a nice profit in his personal account. This is a front running violation.

20. The best answer is **a.** A short straddle is the sale of a call and a put on the same stock, with the same strike price and expiration. The customer essentially has a short naked call position and a short naked put position, for which a double premium is collected. If the market does not move, both contracts expire and the customer collects a double premium (maximum gain). However, as the market moves up the customer loses on the short naked call; and as the market moves down, the customer loses on the short naked put. As an example, assume that when the market price of ABC stock is $50, the customer takes the following positions:

Sell 1 ABC Jan 50 Call @ $4
Sell 1 ABC Jan 50 Put @ $4

Net Credit $8

The maximum gain is the $800 credit received if the market stays at 50 and both contracts expire "at the money." If the market rises above $50, the short naked call will be exercised, obligating the customer to deliver the stock that he does not own at $50.

Since the price at which the shares must be purchased for delivery can rise an unlimited amount, there is unlimited risk. If the market falls, the short put is exercised, obligating the customer to buy the stock at $50. Since the stock can fall to "0," the customer can lose $5,000, net of the $800 premium credit received. If the customer wants to limit these losses, the customer could add the following positions to the short straddle:

Buy 1 ABC Jan 55 Call @ $2

Sell 1 ABC Jan 50 Call @ $4
Sell 1 ABC Jan 50 Put @ $4

Buy 1 ABC Jan 45 Put @ $2

Net Credit $4

Instead of collecting $8, the customer collects $4. This is the maximum gain if the stock stays at $50 and all positions expire. If the stock rises above $55, the long call is exercised, limiting the upside loss to 5 points, net of $4 collected, equals a net $1 loss. If the market falls below $45, the long put is exercised, limiting the downside loss to 5 points, net of the $4 collected, equals a net $1 loss. This position is profitable when the market is flat and is called a butterfly spread. The 2 short positions are the body of the butterfly; and the 2 long positions are the wings of the butterfly. A butterfly spread essentially combines a short call spread and a short put spread, and is profitable in a neutral market.

Long straddles are profitable if the market rises or falls, and are unprofitable if the market stays the same. As an example, assume that when the market price of ABC stock is $50, the customer takes the following positions:

Buy 1 ABC Jan 50 Call @ $4
Buy 1 ABC Jan 50 Put @ $4

Net Debit $8

If the price stays at $50, both positions expire and the $8 debit is lost. If the market rises, the customer gains on the long call. If the market falls, the customer gains on the long put.

A short call spread is a bear market strategy. As an example, assume that a customer takes the following positions:

Sell 1 ABC Jan 50 Call @ $4
Buy 1 ABC Jan 60 Call @ $1

Net Credit $3

If the market stays below $50, both positions expire and the customer gains the credit of $3. If the market rises, the short call is exercised, obligating the customer to deliver the stock at $50. At the worst, the customer can buy the stock for delivery by exercising the long 60 call, causing the customer to lose $10 per share on the stock. Since a $3 credit was received, the maximum net loss is $7.

21. The best answer is **a.** A customer that wishes to sell covered calls in a cash account can only do so if the stock is held fully paid in the cash account or if the stock is held fully paid at a bank, as evidenced by an escrow receipt. A bank guarantee letter can cover the sale of a put (where the loss potential is finite), but it cannot cover the sale of a call (since the loss potential is infinite). A long 50 call will cover the sale of a 60 call, but this creates a spread position. Spread positions can only be taken in a margin account - not in a cash account.

22. The best answer is **b.** Index options trade from 9:30 AM - 4:15 PM ET. In contrast, note that stock options trade from 9:30 AM - 4:00 PM ET. Exercise settlement of index options results in a delivery of cash, not the securities that are in the index. Exercise settlement for index options occurs next business day, as opposed to 3 business days for stock options. Finally, most index options are European style, not American style. In contract, almost all equity options are American style, not European style.

23. The best answer is **b.** An accommodation liquidation order is placed by a customer who wishes to receive a closing trade confirmation for a worthless option contract (if one is audited by the IRS, the IRS really appreciates having a closing trade confirmation showing that the option position was liquidated rather than simply having the contract expire). An order is placed to close the contract at an aggregate premium of $1 ($.01 per share). This is a limit order. The board broker or order book official handles these orders as an "accommodation" to the public, hence the name.

24. The best answer is **a.** All exchange traded options contracts, including FLEX contracts, are issued by the OCC and are guaranteed by the OCC.

25. The best answer is **a.** Options confirmations must include the exercise price on a per share basis, not the aggregate exercise price of the entire contract. The exercise style is not a required disclosure; nor is the exercise cut-off date required to be disclosed on the confirmation.

26. The best answer is **d.** Options contracts with "flexible" terms are available on the PHLX, and are called FLEX options. The writer can specify the contract size, strike, underlying instrument, and expiration. The premium, however, is determined in the marketplace by the Specialist. The minimum size for a FLEX option trade is 50 contracts. Also note that FLEX options are now offered on the CBOE as well.

27. The best answer is **d.** Because listed option contracts are adjusted by the OCC for 2:1 and 4:1 stock splits, the number of contracts can be adjusted; the number of shares covered by each contract can be adjusted; and the strike price (exercise price) can be adjusted. The style of the contract (e.g., American or European) is not changed.

28. The best answer is **c.** Front running of customer orders is a prohibited practice. A member firm that receives a large customer order that is likely to have a market impact cannot trade that stock (or options on that stock) for its proprietary account to either take advantage of the market impact of the order or to mitigate the effect of filling the order on its proprietary account. However, once the customer order has been executed

and the trade report has been disseminated publicly, then the member firm may trade that stock (or options on that stock) for its proprietary account.

29. The best answer is **c.** If the exchange stops trading in a stock, options trading stops as well. Any existing orders to buy or sell cannot be filled - they can be canceled however, since this does not involve trading. Even though trading has stopped, any contracts that have been created can still be exercised - since exercises go through the OCC and not through the exchange.

30. The best answer is **b.** A short naked call obligates the writer, if exercised, to deliver stock that he does not own. This creates unlimited loss potential. A short naked put obligates the writer to buy stock at the strike price if exercised. The maximum loss occurs if that stock's value has fallen to zero - thus, the put writer can lose the purchase price of the stock, less any premium received for writing the put. A customer that takes a short stock position has unlimited loss in a rising market, but if the customer buys a call on that stock, it allows the customer to buy that stock at a fixed price, limiting upside loss. Finally, if a customer shorts stock and shorts a put, if the market rises, the put expires worthless and the customer is still exposed to unlimited upside loss potential on the short stock position.

31. The best answer is **b.** The Options Clearing Corporation issues listed options contracts and guarantees performance if a contract is exercised. The trading takes place on an exchange. The OCC assigns exercise notices to its customers - who are the member firms. A member firm that receives an exercise notice, in turn, must assign it to one of its individual customers, making Choice **c** incorrect. The premium paid from buyer to seller is established in the trading market - it is not set by the OCC.

32. The best answer is **a.** The OCC assigns exercise notices on a random basis. The member firm, once it receives an exercise notice from the OCC, has a choice of assignment methods - random, FIFO, or any other method that is fair and reasonable.

33. The best answer is **a.** The customer has created a long stock/short straddle position. This is termed a "covered straddle," however this name is not really accurate. The short call is covered by the long stock position; however, the short put is naked.

34. The best answer is **a**. The customer has created a long stock/short straddle position. This is shown following:

Buy 100 Shares of ABC at $40

Sell 1 ABC Jan 40 Call @ $ 4
Sell 1 ABC Jan 40 Put @ $ 2

$ 6 Credit

The credit of $600 is the maximum potential gain occurring if both contracts expire "at the money."

If the market rises above $40, the short call is exercised, while the short put expires "out the money." The stock that was purchased at $40 is delivered for $40 - there is no further gain or loss on this position. Thus, in a rising market, the maximum gain is $600.

If the market falls below $40, the short put is exercised (requiring the customer to buy **another** 100 shares at $40), while the short call expires "out the money" As the market falls, the customer now owns 200 shares purchased at $40. Since $600 was collected in premiums, he can afford to lose 3 points per share and will still breakeven Thus, the breakeven occurs at $40 - $3 = $37. If the market continues to drop to zero, the customer will lose the full value of the 200 shares purchased at $40, net of $600 collected in premiums, for a net loss of $7,400 ($37 per share).

35. The best answer is <u>c.</u> The customer has created a long stock/short straddle position. This is shown below:

Buy 100 Shares of ABC at $40

Sell 1 ABC Jan 40 Call @ $ 4
Sell 1 ABC Jan 40 Put @ $ 2

$ 6 Credit

The credit of $600 is the maximum potential gain occurring if both contracts expire "at the money."

If the market rises above $40, the short call is exercised, while the short put expires "out the money." The stock that was purchased at $40 is delivered for $40 - there is no further gain or loss on this position. Thus, in a rising market, the maximum gain is $600.

If the market falls below $40, the short put is exercised (requiring the customer to buy **another** 100 shares at $40), while the short call expires "out the money" As the market falls, the customer now owns 200 shares purchased at $40. Since $600 was collected in premiums, he can afford to lose 3 points per share and will still breakeven Thus, the breakeven occurs at $40 - $3 = $37. If the market continues to drop to zero, the customer will lose the full value of the 200 shares purchased at $40, net of $600 collected in premiums, for a net loss of $7,400 ($37 per share).

36. The best answer is <u>c.</u> Bear put spreads are a bearish strategy. Below is an illustration of a bear put spread:

Bear Put Spread - Profitable in Falling Market

Long 1 ABC Jan 70 Put @ $7
Short 1 ABC Jan 60 Put @ $3

Net Debit $4

This is a debit spread. If the market falls, both puts go "in the money" and are exercised. The customer winds up buying the stock at 60 and selling for 70, for a 10 point profit. Since 4 points was paid in net premiums, the net profit is 6 points or $600. If the market rises, both puts expire "out the money" and the customer loses the debit.

Since this is a debit spread, it would be closed with a credit. To profit, the closing credit must be larger than the opening debit. Thus, the spread between the premiums must widen.

62. The best answer is **c.** To sell covered calls in a cash account, the customer must be long the underlying security, either held by the brokerage firm; or held in an OCC recognized depository as evidenced by an escrow receipt. Thus, if the call is exercised, the brokerage firm or depository will deliver the underlying securities. The purchase of a call contract only covers the sale of a call if the strike price of the long call is the same or lower; and the expiration of the long call is the same or later. Furthermore, this creates a spread position, and spreads are only permitted in margin accounts (with some very rare exceptions).

37. The best answer is **c.** The purchase of calls and the sale of puts are both bullish strategies (Choices I and II). Choice III is a bull call spread - a bullish strategy. Choice IV is a bear put spread - a bearish strategy. Below are illustrations of bull call spreads and bear put spreads:

Bull Call Spread - Profitable in Rising Market

Long 1 ABC Jan 60 Call @ $7
Short 1 ABC Jan 70 Call @ $3

Net Debit $4

Bear Put Spread - Profitable in Falling Market

Long 1 ABC Jan 70 Put @ $7
Short 1 ABC Jan 60 Put @ $3

Net Debit $4

38. The best answer is **c.** Supporting is an illegal practice that might be attempted by an individual who is short puts that are near expiration, and that he believes may go "in the money" (the stock falls in price). To stop this, this person could **buy** the underlying stock in a sufficient amount to "support" the market price, and keep the puts "at the money" until expiration. "Capping" is a similar illegal strategy for an individual who is short calls that are near expiration, and that he believes may go "in the money" (the stock rises in price). To stop this, this person could **sell short** the underlying stock in a sufficient amount to "cap" the market price, and keep the calls "at the money" until expiration. Pegging is another illegal practice, where a person who is short straddle (and thus would lose if the market moves **either** up or down), engages in transactions to "peg" the market - that is, keep the price constant so that neither side of the straddle goes "in the money."

39. The best answer is **d.** Floor brokers on the Chicago Board Options Exchange can execute **all** orders. They may accept market orders, limit orders, stop orders, spread orders, and straddle orders. They may only accept these orders from other member organizations; they cannot accept orders directly from the public.

40. The best answer is **c.** The basic rule for setting of options strike prices at issuance is that the strike is based on the current market price of the stock. For example, if the strike price interval is $2.50 and a stock is trading at $18, at that moment, new contracts cannot be issued at $18, but they could be issued at, say, $17.50, $20.00, $22.50, etc. For each stock trading at $20 or less, strike prices can be issued up to 100% higher or lower;

for stocks over $20, the range is +/- 50%. So if a stock is trading at, say, $50, options can be issued with strike prices ranging from $25 to $75.

41. The best answer is **d.** If a market is deemed to be "Fast," Floor Officials may restrict the entry of stop orders, stop-limit orders, and market-if-touched orders. During trading, if these orders happen to be "bunched" at a specific price, and a trade occurs at that price, then they are triggered, and a flood of new market orders to either buy or sell could enter the market, worsening the situation. This is why entry of these orders would be restricted until the market calms down.

42. The best answer is **c.** If a put is exercised just prior to the ex-dividend date, the put writer is buying the stock early enough to show as an owner of record for that dividend distribution. Thus, the put writer would receive the dividend from the issuer, while the put holder (who sold that stock) would not receive the dividend. Please note that if the put were exercised **after** the ex-dividend date, the situation would have been reversed.

43. The best answer is **a.** An accommodation liquidation order is placed by a customer who wishes to receive a closing trade confirmation for a worthless option contract (if one is audited by the IRS, the IRS really appreciates having a closing trade confirmation showing that the option position was liquidated rather than simply having the contract expire). An order is placed to close the contract at an aggregate premium of $1 ($.01 per share). This is a limit order. The board broker or order book official handles these orders as an "accommodation" to the public, hence the name.

44. The best answer is **c.** Prior to executing orders for the firm account at the same, or better prices, any existing customer orders at those prices must be filled. The firm is prohibited from "front running" customer orders. Market makers on the CBOE floor are permitted to trade for their own accounts at prices that do not compete with existing customer orders - otherwise the customer orders have priority. Since customer limit orders are filled on a "first in, first out" basis, an existing customer limit order might not be filled if there were orders ahead of this customer order. Because of the "spread priority rule" which gives preference to filling spread and straddle orders on the trading floor, an existing customer buy limit order might not be filled because one "leg" of the spread or straddle position was filled at the same price and took priority.

45. The best answer is **d.** If one shorts stock, there is increasing gain in a falling market; and increasing loss in a rising market. Unlimited loss is only possible in a rising market. If a call is bought on that stock, then in a rising market, the customer can buy in the stock at a fixed price to cover the short stock position, limiting upside loss potential. If a put is sold against that stock, then in a rising market, the put would expire "out the money." The customer is left with the short stock position, which has unlimited loss potential in a rising market.

46. The best answer is **c.** To participate in a tender offer, the customer must be "long" the stock. A customer is "long" if the customer owns an option, right or warrant on that stock **and** has exercised (so we know that the stock is actually coming in). A customer is "long" if the customer owns a convertible security (into that stock) **and** has given irrevocable instructions to convert.

47. The best answer is **c.** Money laundering is the conversion of funds obtained through illegal actions into "legitimate" funds - so the money is "washed clean." Money laundering is illegal and firms must have procedures in place to detect and report (to the Department of Treasury) suspected money launderers. In contrast, wash sales are

sequences of buy and sell trades in the same security by the same person to give the appearance of trading activity, without any actual change of ownership of the security.

48. The best answer is **a.** Reports of stolen securities or receipt of counterfeit securities must be made to SIC (Securities Information Center) within 1 business day of discovery. Securities discovered to be missing as a result of a routine securities count do not have to be reported until 10 days elapse without finding the securities. Reports of securities that are lost (no criminal activity suspected) are not required to be made until 2 business days after discovery. There is no requirement to report the receipt of bearer bonds that are missing coupons.

49. The best answer is **d.** A customer is "long" if the customer owns an option, right or warrant on that stock **and** has exercised (so we know that the stock is actually coming in). Similarly, if a customer is short a put and it has been exercised, we know that the customer will be receiving the stock - so the customer is "long." A customer is "long" if the customer owns a convertible security (into that stock) **and** has given irrevocable instructions to convert. If a customer simply owns a right, call, or warrant; is short a put; or owns a convertible; this is not considered to be "long" the underlying stock until the action is taken to turn that instrument into that stock.

50. The best answer is **b.** The term "class of option" means all options contracts of the same type covering the same underlying security. Thus, all XYX Calls are a "class" and all XYX Puts are a "class." The term "series of options" means all options contracts of the same class having the same exercise price and expiration date. Thus, all XYX Jul 50 Calls are an options series.

51. The best answer is **a.** Reverse splits are very rare events. Essentially, the standpoint of the Options Clearing Corporation is that they leave the contract untouched, but if there is an exercise, they will "fix" the problem. Logically, if there is a reverse 1:3 stock split, then the strike price should be 3 times as much; and the contract size should become 1/3rd of the normal 100 share unit. But, instead, the OCC keeps all the terms of the contract unchanged. However, if there is an exercise, the holder would be buying 33.33 shares at $30, for an aggregate value of $1,000. The OCC calls this an adjustment to the "deliverable unit." So for a reverse stock split, the contract terms are not changed, but the "deliverable unit" is changed.

52. The best answer is **d.** The CBOE may halt trading in a specific option contract if two Floor Officials agree that trading should be halted. The length of the halt can be no more than 2 business days. Reasons for halting trading in a specific stock option contract are:

1) Trading in the underlying security has been halted in the security's primary market;

2) The opening of trading in the underlying security has been delayed because of unusual market conditions; and

3) Other unusual conditions or circumstances are present.

53. The best answer is **d.** Portfolio margin, which is risk-based as opposed to strategy-based, reduces margins for hedged stock positions and hedged stock portfolios. To hedge stock positions, listed options, unlisted derivatives, securities futures, warrants and index warrants may be used. Portfolio margins cannot be used for bond positions. This is the

case because they already have very low margins (for example, the margin on corporate bonds is the greater of 7% of face or 20% of market value).

54. The best answer is **a.** A customer that has submitted a dispute to mediation has entered into a process from which the customer can withdraw at any time. There is no requirement for consent from the mediator, the other party to the dispute, or from FINRA in order to withdraw. The dispute will then go to arbitration for resolution.

55. The best answer is **c.** "Structuring" is the illegal patterning of cash transactions so they fall under the $10,000 reporting limit - such patterns require the filing of an SAR (Suspicious Activity Report) and a Form 104 CTR (Currency Transaction Report) with FinCEN. The SAR is filed within 30 days; the CTR is filed within 15 days.

56. The best answer is **c**. A market maker cannot declare a "FAST" market - it can only be declared with the approval of 2 Floor Officials. If an options market is "FAST," meaning that trading is exceptionally heavy, the Exchange rules provide for the following measures to help execute all of those orders. The exchange may shift trading in that class of contracts to alternate posts, increasing the number of locations at which trading may occur. The exchange may allow other Board Brokers or Order Book Officials and their clerks to execute transactions in that class of contracts, increasing the number of personnel trading that class of contracts. If trading becomes disorderly, the Exchange may impose trading rotations in that class of contracts.

57. The best answer is **d**. Assume a customer sells 1 ABC Jan 50 Call @ $5. If the market falls, the call expires and the gain is 5 points. If the market rises, the call is exercised, obligating the customer to sell the stock at $50. Since $5 was collected in premiums, the customer will breakeven if the stock can be purchased at $55. If the stock continues to rise, the customer can lose an unlimited amount. Compare this to a customer who:

Sells Short 100 Shares of ABC Stock @ $50
Sells 1 ABC Jan 50 Put @ $5

If the stock falls below $50, the short put is exercised. The stock that was sold short for $50 must be purchased at $50. The customer makes the $5 point premium only.

If the market rises, the short put expires. The customer received $50 for shorting the stock, and received another $5 in collected premiums, for a net receipt of $55 per share. This is the breakeven point. If the market continues to rise, an unlimited amount can be lost on the short stock position.

Thus, this position (Short Stock / Short Put) is exactly the same as a Short Call.

58. The best answer is **b**. Position limits are applied to each "side" of the market. Short calls and long puts represent the "down" side of the market; while long calls and short puts represent the "up" side of the market.

59. The best answer is **c.** Only common stockholders have voting rights, preemptive rights, and subscription rights (basically the preemptive right to subscribe to additional common shares offered by the issuer). Preferred stock does not have these rights. However, both common and preferred have the right to a cash dividend, if declared by the Board of Directors.

60. The best answer is **b.** A 5:4 split is a 1.25:1 stock split. Thus, for every 100 shares held, the owner will now have 1.25 x 100 = 125 shares. The market price of the stock will be adjusted to $50/1.25 = $40 per share. Note that the value of the aggregate holding ($5,000) does not change.

61. The best answer is **c.** Delta measures an options premium change as compared to the price movement of the underlying instrument. Gamma measures the change in options delta, that is how slowly or quickly delta is moving. As an out the money option gets close to being at the money, the rate of premium change accelerates and the gamma is the greatest. An option that is deep out the money has a gamma of "0" - the premium does not move as the stock price moves, since the option is basically worthless. An option that is in the money also has a gamma of "0" since the premium moves in lock-step, dollar-for-dollar, with the stock's price movement. Therefore, gamma is greatest for an option that is right at the money and it diminishes the deeper the option goes in or out the money.

62. The best answer is **a.** An SRO is a "self-regulatory organization" under SEC oversight - each stock exchange is an SRO (CBOE is an exchange floor) as is FINRA. They are registered with the SEC and their rules are approved by the SEC. SIPC is Securities Investor Protection Corp. - which is non-profit membership corporation, funded by member firms, that protects customer accounts from monetary loss in the event that their broker-dealer fails (maximum coverage is $500,000 per account). SIFMA is the Securities Industry and Financial Markets Association, the trade group that represents the views of brokerage firms to Congress and the media.

63. The best answer is **d.** Rule 10b-18 sets ground rules for issuers or affiliated persons who wish to buy their shares in the open market. If an issuer aggressively buys its stock in the market, or bids for its stock, it can manipulate the market price upwards. Bids and purchases that are made in compliance with Rule 10-b-18 will not be considered manipulative activities under Rule 10-b-5 ("catch-all" fraud rule). Rule 10-b-18 purchases, as they are known:

Must be effected through 1 broker/dealer on any given day;

Cannot be the opening transaction;

Cannot be executed within 10 minutes of market close if the security is "actively traded" as designated by Rule 101 of Regulation M, otherwise, the purchase cannot be executed within 30 minutes of market close;

Must be effected at prices no higher than the current highest independent bid for that security or last reported sale price (whichever is higher);

Cannot exceed 25% of the trading volume in the security that day (except for block purchases handled outside the normal flow of orders).

In essence, the rule says that if an issuer buys in its stock during market "quiet" hours; does not bid up the price of the stock; and does not buy too aggressively; then it will not be considered to be manipulating the price of its own securities. Generally, corporations buy back shares and either retire them (increasing reported Earnings Per Share) or use them to fund pension and stock option plans.

64. The best answer is **b.** NASDAQ MarketWatch is similar to the NYSE StockWatch department - both monitor securities price movements and trading volumes in their respective markets to detect potential "insider trading" and "front running" abuses. In addition, MarketWatch has responsibility for receipt of material corporate news announcements to assess whether a trading halt is needed; and receives reports of clearly erroneous trades from members and resolves them. The FINRA Market Regulation Department is responsible for monitoring market makers for rule compliance.

65. The best answer is **a.** Price improvement means that the market maker improves on the best quoted prices by at least 1 cent (e.g., buy for a customer at least 1 cent lower than the inside ask; or sell for a customer at least 1 cent higher than the inside bid). The spread itself is irrelevant.

66. The best answer is **d.** A "block" trade under Regulation NMS is a trade of 10,000 shares or more; or a trade with a value of $200,000 or more. Block trades executed as "stopped" orders, where there is a guaranteed minimum price to sell or a maximum price to buy, are exempted from the "trade-through" rule of Regulation NMS.

67. The best answer is **a.** Rule 611 of Regulation NMS, the "trade-through" rule, only applies during the regular Market trading session of 9:30 AM - 4:00 PM ET. It does not apply to the Premarket or Aftermarket trading sessions.

68. The best answer is **d.** SEC Regulation ATS (Alternative Trading System) regulates ECNs, crossing networks operated internally by a member firm or open to the public, and dark pools. These are regulated as "broker-dealers" and not as exchanges. Each ATS must register with the SEC. Regulation ATS requires that:

An ATS with **less** than **5%** of the volume in all securities it trades to:

file a notice of operation and quarterly reports;
maintain records and an audit trail of transactions;
refrain from using the word "exchange" to describe itself.

An ATS with **5% or more** of the trading volume in an NMS security:

must link with a registered market to comply with Rule 611 (the trade-through rule).

An ATS with **20% or more** of the trading volume in any security:

cannot apply discriminatory standards for access to the system;
must establish procedures to insure adequate system capacity, integrity and contingency planning.

69. The best answer is **c.** An order ticket to buy must include customer name or account number; whether the trade was solicited or unsolicited; and if the customer does not want the order price reduced on ex date for a cash dividend, the marking "DNR" - Do Not Reduce. Once the trade is executed, the confirmation must include whether the firm acted as an agent or principal in the transaction. This information is not on the order ticket, since at the time the order is placed, the details of how it will be executed are unknown.

70. The best answer is **a.** Regulation NMS requires a "level playing field" for trading of NMS securities (NYSE, AMEX and NASDAQ issues). Each member must use a trading system that is NMS compliant, but cannot be forced to use a particular trading system. The system must be able to access quotes and trade NMS securities at the best price posted by any market (exchange, NASDAQ or ATS). Regulation NMS does not ban access fees, but it does limit them to $.003 per share. Finally, quotes that will lock or cross a market cannot be entered into a trading system for an NMS security.

71. The best answer is **d.** SEC Rule 606 of Regulation NMS requires broker-dealers to do the following:

The fact that the firm made a payment for order flow must be disclosed on the customer trade confirmation.

The firm, on request of the customer, must disclose the identity of the market to which the customer's orders were routed for execution in the preceding 6 months along with the time of execution. (These are known as "non-directed" orders, since the customer did not tell the broker the specific market where the order was to be executed, so the member firm could route the order to wherever it wanted.)

The firm must notify customers, in writing, at least annually, of the availability of this information.

In addition, the rule requires member firms to prepare a quarterly report that is publicly available that details the

Percentage of customer orders that were "non-directed";

Identity of the 10 largest markets or market makers, to whom non-directed orders were routed and any other venue that received 5% or more of the firm's orders; and

Member firm's relationship with that market maker (for example, many larger retail member firms own their own market maker subsidiaries to whom they route orders);

Arrangement, if any, for payment for order flow or profit-sharing.

Because of this rule, member firms cannot have "hidden" arrangements with market makers to favor them in return for "payment for order flow" - everything is out in the open and is fully disclosed. Thus, customers can make informed decisions about how retail member firms are routing and executing their orders.

72. The best answer is **d.** If, during normal market hours, a firm attempts to lock the market, the order will be routed to the market participant next in line for execution, at the locking price. NASDAQ Single Book will not allow the display of locking or crossing quotes during normal market hours.

73. The best answer is **b.** Regulation SHO requires that every order ticket to sell be marked either "long" or "short." An order to sell a security is "long" if the customer is long a convertible security and tenders it for conversion. The SEC recognizes that the transfer agent will take longer than 3 business days to cancel the bonds and issue shares in their place, so it gives 35 days for delivery before the securities must be bought in. The mandatory buy in of "13 settlement days" only applies to short sales of securities on the "threshold list" that are not delivered on settlement.

74. The best answer is **a.** Syndicate members who are not market makers are prohibited from purchasing, making a bid for, or inducing the purchase of, the subject security during the restricted period. They may, however execute unsolicited orders during this period. However, if a syndicate member inadvertently purchases the subject security during the restricted period in an amount that totals less than 2% of the security's ADTV (Average Daily Trading Volume), the SEC will overlook the violation as the firm has procedures in place designed to achieve compliance with Rule 101 of Regulation M (consider this a learning question!). There is no requirement for the firm to resign the syndicate.

78. The best answer is **d.** Under SEC rules, a customer is considered to be "long" only to the extent of his net long position in a security. It makes no difference that the positions are split among different accounts at the brokerage firm. This customer is long 500 shares of ABC and short 300 shares of ABC for a "net" long position of 200 shares. If the customer wishes to sell 500 ABC shares, the first 200 shares are sold "long," with the remaining 300 shares being a "short" sale.

79. The best answer is **d.** The Limit Order Protection Rule applies to all customer limit orders, with the exception of orders for Pink Sheet issues.

80. The best answer is **b.** Under FINRA's "Trading Ahead of Research" rule, a member firm that is about to release a research report on an issuer in which it is a market maker, cannot change its inventory position (either increase or decrease) in response to the anticipated impact of the release of the report. It can, however, increase or decrease its inventory in response to unsolicited customer order flow. The rule also strongly recommends that member firms place Chinese Walls between research and the member firm's trading desk to insure that research report information does not get transmitted to the trading desk until the report is released.

81. The best answer is **b.** The "Manning Rule" is another name for the Limit Order Protection Rule, which prohibits member firms from trading ahead of customer limit orders.

82. The best answer is **b.** Asking another dealer to either tighten or widen its spread is a prohibited practice - such coercive action was one of the major violations that occurred during the NASDAQ "Price Fixing Scandal" that was uncovered in the mid- 1990's. The other actions are all just fine - a dealer is free to offer more shares than that displayed on NASDAQ (though the dealer cannot refuse to trade less than its displayed size); a dealer can honor a bid that another dealer has just refused to honor (note, however, that other dealer has committed a "backing away" violation); and negotiating prices between the current best bid and offer is what human traders are hired to do!

83. The best answer is **a.** Executing trades for the purpose of inducing customers to either buy or sell is a manipulation. The other choices offered are illegal or unethical, but they are not a market manipulation. Refusing to honor customer instructions (Choice b), front running a customer order (Choice c), and backing away from a firm quote (Choice d), are all prohibited but they are not actions that manipulate the market.

84. The best answer is **c.** Customer short sales not resulting in delivery must be bought-in after 10 business days from settlement, if the security was on the exchange's or NASDAQ's threshold list as of trade date under Regulation SHO and remains on that list for 10 business days past settlement. The actual rule uses the wording that "buy-in" must occur in 13 settlement days - but this is the same as 10 business days after settlement

since 3 additional days are needed to get from trade date to settlement date. Threshold securities are those that are "hard to borrow" and the SEC does not want large outstanding short positions that are uncovered to build in these securities. A threshold security is one with a large outstanding short position - defined as one with a clearing short position at the National Securities Clearing Corporation of 10,000 shares or more; and the position represents 1/2% or more of the total shares outstanding.

85. The best answer is **d.** The "Best Execution" rule requires that a member firm use reasonable diligence to ascertain the best market for the security being traded, taking into consideration:

The character of the market for the security, including price, volatility, relative liquidity and pressure on available communications;

The size and type of transaction;

The number of markets checked;

Accessibility of the quotation; and

The terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.

86. The best answer is **b.** Exercise of an option results in a regular way trade. Stocks settle regular way 3 business days after trade date. Since the ex-date is set at 2 business days prior to the record date, to receive the dividend the stock must be bought 3 business days prior to the record date (or just prior to the ex-date). Exercising the call just prior to the ex-date is the same as buying the stock in a regular trade just prior to the ex-date.

87. The best answer is **b.** Cumulative voting gives the shareholders disproportionate voting weight as compared to statutory voting and is considered to be an advantage to the small investor. Under the statutory method, the shareholder can apply as many votes per directorship as he has shares in the company. Under the cumulative method, the shareholder can accumulate **all** votes that he has for **all** directorships and apply them to favored individuals.

88. The best answer is **b.** Listed option contracts are **not** adjusted for cash dividends. They are adjusted for 2:1 and 4:1 stock splits.

89. The best answer is **a.** Common shareholders have both voting rights and preemptive rights (the right to maintain proportionate ownership if the issuer issues additional common shares). Preferred stockholders do not have voting rights and do not have preemptive rights. This is the case because they are being given a fixed rate of return that is not affected by dilutive actions taken on the part of the company (as is the case with common shareholders).

90. The best answer is **b.** Money laundering is typically characterized by extensive deposits or withdrawals of cash, money orders, and wire transfers - especially to overseas accounts in countries with tight bank secrecy laws. The wire transfer request is the "tip off" to this question.

91. The best answer is **b.** An ETN is an Exchange Traded Note. It is a type of structured product offered by banks that gives a return tied to a benchmark index. The note is a debt of the bank, and is backed by the faith and credit of the issuing bank. Thus, if the bank's credit rating is lowered, the value of the ETN will fall as well - so it has credit risk. ETNs are listed on an exchange and trade, so they have minimal liquidity risk. Their return can be based on "exotic" indexes, such as a Brazil or India index, so they can give investors access to the returns of foreign markets. Finally, ETNs make no interest or dividend payments. Their value grows as they are held based on the growth of the benchmark index, with any gain at sale or redemption currently taxed at capital gains rates. Thus, they are tax-advantaged as compared to conventional debt instruments.

92. The best answer is **c.** An ETN is an Exchange Traded Note. It is a type of structured product offered by banks that gives a return tied to a benchmark index. The note is a debt of the bank, and is backed by the faith and credit of the issuing bank. They are not an equity security - they are a debt instrument. ETNs are listed on an exchange and trade, so they have minimal liquidity risk. Finally, ETNs make no interest or dividend payments. Their value grows as they are held based on the growth of the benchmark index, with any gain at sale or redemption currently taxed at capital gains rates. Thus, they are tax-advantaged as compared to conventional debt instruments.

93. The best answer is **a.** Failure to honor a stated quote is the violation known as "backing away" - as in backing away from that quote.

94. The best answer is **c.** The term "DNR" stands for "Do Not Reduce." On the ex-date for a cash dividend, the price of the stock is reduced by the dividend amount and the orders that are below the current market are also automatically reduced. These are Open Buy Limit orders and Open Sell Stop orders ("OBLOSS"). Because the dividend reduction reduces the opening price on ex-date, these orders could wind up being automatically filled just due to the dividend reduction - so reducing them stops this from happening. If the customer does not want the order automatically reduced, then "DNR" - Do Not Reduce - must be noted on the order.

95. The best answer is **d.** The Securities Information Center (SIC) is a database for reports of securities that are lost, stolen, or discovered to be counterfeit. Receipt of a bearer bond that is missing coupons is not reported to SIC. Receipt of such a bond is not a good delivery (bearer bonds must be delivered with all unpaid coupons attached) and a member firm can use the Uniform Practice Code's "Reclamation Procedure" to return the bond to the seller and replace it with another bond that has all unpaid coupons attached.

96. The best answer is **d.** A sell order can only be marked "long" if the representative determines the location of the securities and that they can be delivered by settlement. The location of street name securities held by the broker-dealer is known, and because these are held at the firm, they can be delivered by settlement. Customer securities held in the customer's safe deposit box are in a known location, and Choice B states that the customer will deliver by settlement, so the sell order is marked "long." Securities held at Depository Trust Corp. in book entry form have no physical certificates. As long as they are recorded as owned by the customer at DTCC, then the sell order can be marked "long." In Choice D, we have no clue as to the location of the securities, so this sell order must be marked "short."

97. The best answer is **a.** FINRA permits claims that would be (or that have been) submitted to arbitration to be submitted to a mediator for an attempt at resolution. The mediator is simply an impartial facilitator that attempts to get both sides to find an amicable settlement. The mediator has no decision-making authority and cannot force a resolution of the dispute. This is a voluntary process - no one can be compelled to go to mediation. Both sides must agree to mediation, and either side can exit the process at any time (at least until the point that they agree to a settlement and sign the papers!).

98. The best answer is **a**. Since trading has been halted in the U.S., the trading halt applies to all U.S. market participants. The fact that the issue is still trading in the foreign market is irrelevant.

99. The best answer is **d.** The minimum maintenance margin requirement for short positions is 30% of market value. However, because the ETF is 300% leveraged, the minimum is 3 times 30% = 90%. These leveraged ETF margin rules were put in place because of the excessive volatility that these securities have shown.

100. The best answer is **b.** SEC Rule 10b-5-1 allows officers of publicly held companies (statutory insiders) to establish "pre-arranged trading plans" that set future transaction dates and amounts of that issuer's securities; or that specify algorithms that establish the transaction dates and amounts. As long as the officer does not deviate from the plan, the officer is given a "safe harbor" from being accused of insider trading based on those trades.