<u>Learning Module 1: Market Organization & Structure</u>

Q.99 When investing in the stock markets, what is *most likely* the initial margin?

A. The portfolio's total value.

B. The investment's total value.

C. The minimum amount of equity required by an investor.

The correct answer is **C.**

The initial margin refers to the minimum amount of equity that an investor is required to provide when purchasing securities on margin. This requirement is set by regulatory bodies such as the Federal Reserve in the United States, as well as by individual brokerage firms, and is designed to protect both the investor and the brokerage firm from the potential losses that can occur in a leveraged transaction.

The initial margin requirement ensures that the investor has a stake in the investment and provides a buffer against market fluctuations. By requiring a certain percentage of the purchase price as the initial margin, regulatory authorities and brokerage firms aim to mitigate the risk of loss due to a decline in the value of the securities purchased on margin.

A is incorrect. Suggesting that the initial margin is the portfolio's total value is misleading. The portfolio's total value encompasses all the investments held by an investor, including cash, stocks, bonds, and other securities. The initial margin, however, specifically refers to the minimum equity contribution required when purchasing securities on margin, not the total value of an investor's portfolio.

B is incorrect. The initial margin requirement is a regulatory and risk management tool, ensuring that the investor has sufficient skin in the game and that the leverage used does not exceed prudent levels.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (f) Calculate and interpret the leverage ratio, the rate of return on a margin transaction, and the security price at which the investor would receive a margin call.

Q.100 A stop-sell order is often placed when a trader:

A. wants to enter a long position.

B. wants to limit the loss on a long position.

C. wants to double down on a long position.

The correct answer is **B.**

A stop-sell order, also known as a stop-loss order, is a trading strategy used to limit potential losses on an investment. It is a directive to sell a security when it reaches a specific price point, known as the stop price. This mechanism is particularly useful in managing risk and protecting investment capital in volatile markets. When the market price of a security drops to the stop price, the stop-sell order is triggered and executed, thereby capping the investor's loss.

A is incorrect. Wanting to enter a long position involves buying a security with the expectation that its price will rise over time. A stop-sell order does not facilitate this objective; instead, it is a risk management tool used to limit potential losses on existing positions. Entering a long position would typically involve a buy order, not a stop-sell order, which is designed to execute a sale when a security's price falls to a certain level.

C is incorrect. Doubling down on a long position means purchasing additional shares of a security that an investor already owns, with the expectation that its price will rebound and increase. This strategy is used to lower the average cost per share of the investment, potentially leading to higher gains if the price indeed increases. A stop-sell order, on the other hand, is a protective measure to exit a position and limit losses when the price of a security is falling, not to acquire more shares at a lower price.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (g) Compare execution, validity, and clearing instructions.

Q.101 An investor buys 100 shares of a stock on a margin at $146 a share using an initial leverage ratio of 2. At what stock price will he receive a margin call if the maintenance margin requirement for the position is 40%?

A. $58.40

B. $116.80

C. $121.67

The correct answer is **C.**

To determine at what stock price an investor will receive a margin call, we need to understand the relationship between the initial leverage ratio, the maintenance margin requirement, and the stock price. The initial leverage ratio of 2 means that for every dollar of equity, the investor is borrowing another dollar, effectively doubling the potential investment but also the risk. The maintenance margin requirement of 40% is the minimum percentage of the total value of the securities that must be maintained as equity to avoid a margin call.

Given the initial leverage ratio of 2, the investor puts up half of the investment as equity. Therefore, for a stock bought at $146 a share, the equity contribution is $73 per share ($0.5 \times \$146$). The maintenance margin requirement dictates that the equity must always be at least 40% of the market value of the stock. If the stock price falls, the equity as a percentage of the stock value decreases. A margin call occurs when this percentage falls below the maintenance margin requirement.

$$\begin{aligned}
\text{Leverage ratio } &= \frac{1}{2} = 0.5 \\
\text{Initial equity per share} &= 0.5 \times \$146 = \$73 \\
\frac{(\$73 + \text{P} - \$146)}{\text{P}} &= 0.40 \\
\$73 + \text{P} - \$146 &= 0.40\text{P} \\
\$73 - \$146 &= \text{-}0.60\text{P} \\
-\$73 &= \text{-}0.60\text{P} \\
\text{P} &= 121.67
\end{aligned}$$

Note that the leverage ratio is the ratio of the position's value to the value of the equity investment and indicates how many times larger a position is than the equity that supports it.
The maximum leverage ratio associated with a position financed by the minimum margin requirement is one divided by the minimum margin requirement, which in this case is 0.5, i.e., 1/2.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (f) Calculate and interpret the leverage ratio, the rate of return on a margin transaction, and the security price at which the investor would receive a margin call.

Q.806 A stock is selling for $50. An investor's valuation model estimates its intrinsic value to be $40. Based on his estimate, he would *most likely* place a:

A. short-sale order.

B. stop order to buy the security.

C. market order to buy the security.

The correct answer is **A.**

When an investor's valuation model estimates the intrinsic value of a stock to be lower than its current market price, it indicates that the stock is overvalued. In this scenario, where the stock is selling for $50 but is estimated to be worth only $40, the investor would most likely consider the stock to be overpriced compared to its intrinsic value. A rational response to this assessment is to place a short-sale order.

A short sale involves borrowing shares of the stock and selling them at the current market price with the expectation that the price will decrease. Later, the investor plans to buy back the same number of shares at a lower price to return to the lender, profiting from the difference. This strategy is based on the belief that the stock's price will decline, aligning with the investor's valuation.

B is incorrect. A stop order is designed to limit an investor's loss on a security position. It becomes active only when the stock reaches a specified price, known as the stop price. In the context of believing that a stock is overvalued, placing a stop order to buy would not align with the investor's strategy. The investor's goal is to profit from the stock's price decline, not to set a condition for purchasing the stock at a potentially higher price in the future.

C is incorrect. A market order is an order to buy or sell a stock at the best available current price. It does not consider the investor's assessment of the stock being overvalued. If the investor places a market order to buy the stock at its current price of $50, which is above the estimated intrinsic value of $40, it contradicts the investor's valuation. The investor's objective is to profit from the expected decrease in the stock's price, not to acquire the stock at a price considered overvalued.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (e) Compare positions an investor can take in an asset.

Q.808 Which of the following is a security that entitles the holder to buy the underlying stock of the issuing company at a fixed price called the exercise price until the expiry date?

A. A warrant.

B. A common stock.

C. A preferred share.

The correct answer is **A.**

A warrant is a financial instrument that gives the holder the right, but not the obligation, to buy the underlying stock of the issuing company at a predetermined price, known as the exercise price, until a specified expiry date. This characteristic makes warrants particularly attractive to investors who anticipate the underlying stock's price will increase in the future, allowing them to purchase the stock at a price lower than the market value.

B is incorrect. Common stock represents ownership in a company and entitles the holder to vote at shareholders' meetings and receive dividends. Unlike warrants, owning common stock does not provide the right to buy more shares at a fixed price in the future.

C is incorrect. Preferred shares are a type of equity that often has priority over common stock in dividend payments and upon liquidation but typically does not come with voting rights. Like common stock, preferred shares do not grant the holder the right to purchase additional shares at a predetermined price.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (c) Describe the major types of securities, currencies, contracts, commodities, and real assets that trade in organized markets, including their distinguishing characteristics and major subtypes.

Q.809 Which assets give its owner the right to buy or sell an asset at a specific exercise price at some specified time in the future?

A. A swap contract.

B. An option contract.

C. A forward contract.

The correct answer is **B.**

An option contract grants its owner the right, but not the obligation, to buy (in the case of a call option) or sell (in the case of a put option) an underlying asset at a predetermined price (known as the exercise price or strike price) on or before a specified date.

A is incorrect. A swap contract is a financial derivative that entails two parties exchanging cash flows or other financial instruments over a specified time period. These exchanges are based on a predetermined notional principal amount. Swaps are used primarily for hedging purposes to manage exposure to fluctuations in interest rates, currency exchange rates, or commodity prices.

C is incorrect. A forward contract is a customized contract between two parties to buy or sell an asset at a specified price on a future date. Forward contracts are over-the-counter (OTC) derivatives, meaning they are negotiated directly between parties without going through an exchange.

The key characteristic of a forward contract is its obligation for both the buyer and the seller to execute the transaction at the agreed-upon price and date, making it different from an option, which grants the right but not the obligation to execute the trade.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (c) Describe the major types of securities, currencies, contracts, commodities, and real assets that trade in organized markets, including their distinguishing characteristics and major subtypes.

Q.810 Which of the following does *least likely* act as a financial intermediary?

A. Issuers.

B. Brokers.

C. Insurance companies.

The correct answer is **A.**

Issuers do not typically act as financial intermediaries. Instead, they are entities that create and sell securities to finance their operations. This process involves the direct transfer of funds from investors to the issuer, without the need for an intermediary to facilitate the transaction.

Issuers are primarily involved in raising capital for their own needs, such as funding projects, expanding operations, or refinancing existing debts. They do this by issuing financial instruments like stocks, bonds, and warrants directly to investors.

B is incorrect. Brokers indeed act as financial intermediaries. They play a pivotal role in the financial markets by executing buy and sell orders for their clients, who may be individuals or institutions. Brokers facilitate transactions between buyers and sellers, ensuring liquidity and efficiency in the markets.

They do not own the securities they trade on behalf of their clients, which distinguishes their role as intermediaries rather than direct participants in the capital raising process.

C is incorrect. Insurance companies are essential examples of financial intermediaries. They collect premiums from policyholders and pool those funds to pay out claims as they arise. This process involves the transformation of risk, as insurance companies underwrite policies to protect against a wide range of potential losses, from health-related expenses to property damage.

Their role as intermediaries comes from their ability to pool resources from a large number of policyholders and redistribute them in the form of claims payments, thereby facilitating the efficient allocation of risk within the economy.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (d) Describe types of financial intermediaries and services that they provide.

Q.811 In which of the following types of markets do stocks *most likely* trade at any time the market is opened?

A. Call markets.

B. Exchange markets.

C. Continuous markets.

The correct answer is **C.**

In continuous markets, stocks are available for trading at any given time during market hours. This characteristic allows for a high level of liquidity and flexibility for traders and investors, enabling them to execute trades based on real-time information and market conditions.

Continuous markets are designed to facilitate immediate order execution, which is crucial in today's fast-paced financial environment where prices can fluctuate significantly within short periods. The ability to trade at any moment the market is open provides participants with the opportunity to respond swiftly to news, earnings reports, and economic indicators.

A is incorrect. Call markets operate on a different principle, where trades are not executed continuously but at specific times when buy and sell orders are aggregated and matched at predetermined intervals.

This system can lead to less liquidity and slower reaction times to market changes compared to continuous markets. In call markets, participants must wait until the next call period to execute their trades, which can be disadvantageous in rapidly changing market conditions.

B is incorrect. Exchange markets refer to the broader category of marketplaces where securities, commodities, derivatives, and other financial instruments are traded. While exchange markets can be either continuous or call markets, the term itself does not specify the trading mechanism.

Some exchange markets operate as call markets, and others as continuous markets. The key distinction lies in the trading mechanism (continuous vs. call) rather than the market type (exchange market).

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (i) Define primary and secondary markets and explain how secondary markets support primary markets.

Q.813 A financial intermediary buys a stock and then resells it a few days later at a higher price. Which intermediary would this *most likely* describe?

A. A dealer.

B. A broker.

C. An arbitrageur.

The correct answer is **A.**

A dealer is the financial intermediary most likely to buy a stock and then resell it a few days later at a higher price. Dealers operate by purchasing assets to add to their inventory with the intention of selling these assets at a profit. This business model relies on the dealer's ability to forecast market movements accurately and capitalize on short-term price fluctuations.

By holding an inventory of securities, dealers provide liquidity to the market, allowing for more efficient trading. Their profit comes from the spread between the buying and selling prices of securities. This activity is distinct from that of brokers or arbitrageurs, as it involves taking on the risk associated with owning the securities in inventory.

B is incorrect. Brokers do not buy securities for their inventory; instead, they act as intermediaries between buyers and sellers. Their primary function is to facilitate transactions for clients, earning a commission for their services.

Brokers do not take positions in the securities they trade on behalf of their clients, which differentiates their role from that of dealers. By misunderstanding the fundamental function of brokers, this option fails to accurately describe the activities associated with buying and reselling stocks for a profit.

C is incorrect. Arbitrage involves buying and selling the same security simultaneously in different markets to take advantage of price discrepancies. This strategy is predicated on the principle of risk-free profit that arises from market inefficiencies, without the need to forecast market movements or hold an inventory of securities.

Arbitrageurs contribute to market efficiency by exploiting these price differences, thereby helping prices in different markets converge. The description of buying a stock and reselling it at a higher price does not align with the arbitrage strategy, as it involves taking on market risk and holding an inventory, unlike the risk-free and simultaneous transactions characteristic of arbitrage.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (d) Describe types of financial intermediaries and services that they provide.

Q.814 Which of the following would *least likely* be an objective of market regulations?

A. To reduce accounting standards.

B. To prevent investors from using inside information in securities trading.

C. To make it easier for investors to compare the performance of different firms.

The correct answer is **A.**

Market regulations are designed to enhance the transparency, fairness, and efficiency of financial markets. They aim to protect investors, ensure fair trading practices, and maintain confidence in the financial system. One of the primary objectives of market regulations is to establish and uphold high-quality accounting standards.

These standards ensure that financial statements are accurate, reliable, and comparable across different firms and industries. By requiring companies to adhere to rigorous accounting practices, market regulations help reduce information asymmetry, making it easier for investors to make informed decisions.

B is incorrect. Preventing investors from using inside information in securities trading is indeed a key objective of market regulations. Insider trading undermines market integrity and fairness, as it allows individuals with access to non-public, material information to gain an unfair advantage over other investors.

This ensures that all market participants have equal access to information and that securities prices reflect all publicly available information, thereby maintaining market efficiency and investor confidence.

C is incorrect. Making it easier for investors to compare the performance of different firms is another important objective of market regulations. By enforcing disclosure requirements and accounting standards, regulations ensure that companies provide comprehensive, accurate, and comparable financial information.

This enables investors to assess the financial health and performance of different firms effectively, facilitating informed investment decisions. Comparability of financial information is essential for the efficient allocation of capital and for maintaining a level playing field among investors, which are both fundamental goals of market regulations.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (l) describe objectives of market regulation.

Q.815 Which of the following is *most likely* similar to a short position in the underlying asset?

A. Buying a put.

B. Buying a call.

C. Writing a put.

The correct answer is **A.**

Buying a put option is most similar to taking a short position in the underlying asset. When an investor buys a put option, they acquire the right, but not the obligation, to sell the underlying asset at a predetermined price (strike price) within a specific timeframe.

This strategy is beneficial when the investor anticipates a decline in the asset's price. If the asset's price decreases below the strike price, the value of the put option increases, allowing the investor to sell the asset at a higher price than its current market value. This mechanism mirrors the profit potential of a short position, where the investor profits from the decrease in the asset's price.

B is incorrect. Buying a call option gives the investor the right, but not the obligation, to buy the underlying asset at a predetermined price within a specific timeframe. This strategy is typically employed when the investor anticipates an increase in the asset's price, which is the opposite of the motive behind a short position. In a short position, the investor aims to profit from a decline in the asset's price, making buying a call option fundamentally different in its market outlook and profit mechanism.

C is incorrect. Writing a put option involves the investor selling a put option, which obligates them to buy the underlying asset at the strike price if the option is exercised by the buyer. This strategy can be profitable if the asset's price remains stable or increases, as the writer would keep the premium received from selling the put option. However, this does not align with the characteristics of a short position, where the investor aims to profit from a decrease in the asset's price.

Writing a put option exposes the investor to potential losses if the asset's price declines significantly, contrary to the profit motive of a short position. Therefore, writing a put option is not similar to taking a short position in the underlying asset.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (c) Describe the major types of securities, currencies, contracts, commodities, and real assets that trade in organized markets, including their distinguishing characteristics and major subtypes.

Q.1122 A small investor just bought 100 shares of UYA on margin. The share price of UYA at the time of purchase was \$50, the initial margin requirement is 50%, and the maintenance margin is 30%. Given this information, the margin call trigger price is *closest to*:

A. \$31.25.

B. \$35.71.

C. \$79.

The correct answer is **B.**

To determine the margin call trigger price, we must understand the relationship between the initial margin requirement, the maintenance margin, and the price at which the stock was purchased. The formula to calculate the trigger price for a margin call is given by:

$$\begin{aligned}\text{Trigger price} &= \text{Initial purchase price} \times \frac{1-\text{Initial margin}}{1-\text{Maintenance margin}} \\ &= \$50 \times \frac{(1-0.5)}{(1-0.3)} \\ &= \$35.71\end{aligned}$$

The investor will receive a margin call when the stock price falls to \$35.71.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (f) Calculate and interpret the leverage ratio, the rate of return on a margin transaction, and the security price at which the investor would receive a margin call.

Q.1124 Which of the following *most likely* describes a pure auction market?

A. A market that consists of individual dealers who are assigned specific securities.

B. A market in which participants submit their bid and ask prices to a central location.

C. A market where buying and selling parties are brought together through the activities of a broker.

The correct answer is **B.**

A pure auction market, also known as an order-driven market, is characterized by the direct interaction of buy and sell orders in a centralized location. In this type of market, buyers and sellers submit their bids and asks, respectively, without the need for market makers or dealers.

The prices of securities are determined purely by the supply and demand dynamics as represented by these bids and asks. This system ensures transparency and can lead to more efficient pricing since all market participants have access to the same information regarding buy and sell orders.

A is incorrect. This option describes a dealer market, not a pure auction market. In a dealer market, also known as a quote-driven market, dealers or market makers provide liquidity by buying and selling securities from their own inventory.

They profit from the spread between the buying price (bid) and the selling price (ask). This structure is fundamentally different from a pure auction market, where transactions occur directly between buyers and sellers based on their submitted orders, without intermediaries holding an inventory of securities.

C is incorrect. This describes a brokered market. In a brokered market, brokers act as intermediaries to match buyers with sellers. They do not necessarily operate in a centralized location where bids and asks are openly submitted and matched.

Instead, brokers may seek out potential buyers or sellers individually or use electronic systems to match trades. This process can lack the transparency and direct interaction of bids and asks that are hallmarks of a pure auction market.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (j) Describe how securities, contracts, and currencies are traded in quote-driven, order-driven, and brokered markets.

Q.1125 Which of the following is *least accurate* regarding efficient markets?

A. In an efficient market, it isn't easy to find inaccurately priced securities.

B. In an efficient market, the time frame required for security prices to reflect any new information is concise.

C. In an efficient market, securities may be mispriced, and trading these securities can offer positive risk-adjusted returns.

The correct answer is **C.**

In an efficient market, the concept of securities being mispriced and offering the opportunity for positive risk-adjusted returns contradicts the foundational principles of market efficiency. The Efficient Market Hypothesis (EMH) posits that at any given time, security prices fully reflect all available information.

This hypothesis is built on the premise that markets are rational and that new information is quickly and accurately incorporated into security prices, leaving no room for consistent abnormal returns through trading on such information. Therefore, the assertion that securities may be mispriced and that trading these securities can offer positive risk-adjusted returns is least accurate as it directly conflicts with the essence of an efficient market.

A is incorrect. All available information is already reflected in the prices of securities. This characteristic is a direct implication of the Efficient Market Hypothesis, which suggests that it is not possible to consistently achieve higher returns than average market returns on a risk-adjusted basis by exploiting information that is already reflected in prices.

B is incorrect. This option also accurately describes a feature of efficient markets. In an efficient market, the time frame required for security prices to adjust and reflect any new information is very short. This rapid adjustment is due to the market participants' quick response to new information, ensuring that security prices are always an accurate reflection of all available information.

This efficiency in information processing means that attempting to trade on new information with the expectation of generating abnormal returns is unlikely to be successful, as prices adjust almost instantaneously to reflect this information.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (k) Describe characteristics of a well-functioning financial system.

Q.1127 An investor buys 300 shares of XYZ at the market price of $200 on full margin. The initial margin requirement is 30%, and the maintenance margin requirement is 20%. If the shares are later sold at $250 per share, the margin transaction return is *closest to*:

A. 3.33%.

B. 25%.

C. 83.33%.

The correct answer is **C.**

$$\begin{aligned}
\text{Cash Return} &= \frac{(300 \times 250)}{(300 \times 200)} - 1 \\
&= 25\% \\
\text{Leverage Factor} &= \frac{1}{\text{Initial Margin \%}} = \frac{1}{0.30} \\
&= 3.33 \\
\text{Margin Transaction Return} &= \text{All Cash Return} \times \text{Leverage Factor} \\
&= 3.33 \times 0.25 \\
&= 83.33\%
\end{aligned}$$

Another way of doing this is as shown below.
Gain from the sale of shares:

$$= 300 \times (250 - 200) = 15,000$$

Initial margin requirement (Money out of the investors pocket)

$$= 0.3 \times (300 \times 200) = 18,000$$

Return from the trade

$$= \frac{15,000}{18,000} = 0.8333$$

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (f) Calculate and interpret the leverage ratio, the rate of return on a margin transaction, and the security price at which the investor would receive a margin call.

Q.1128 Which of the following statements is *least likely* accurate?

A. Good-on-close orders are also called market-on-close orders.

B. Fill or kill (FOK) orders are the same as good-on-close orders.

C. Immediate or cancel (IOC) orders attempt to execute the entire order. Any portion not filled immediately gets canceled.

The correct answer is **B.**

FOK orders are distinct from good-on-close orders in that they require immediate execution in their entirety. If the order cannot be fully executed at the moment it is placed, it is canceled altogether.

This contrasts with good-on-close orders, which are executed at the end of the trading day regardless of market conditions. FOK orders are used by traders who are looking for a quick execution at a specific price and are not willing to wait for the market to potentially move against them. This urgency and the requirement for complete fulfillment differentiate FOK orders from good-on-close orders.

A is incorrect. Good-on-close orders, also known as market-on-close orders, are instructions to buy or sell a security at the best available price at the close of the trading day. This type of order ensures that the transaction is executed at the final price of the day, which can be beneficial for investors looking to capitalize on the closing price of a security.

These orders are particularly useful for large institutional investors who wish to minimize the impact of their trades on the market price of a security. By executing at the close, they can avoid causing significant price movements during the trading day.

C is incorrect. Immediate or cancel (IOC) orders and good-on-close orders serve different purposes and operate under different conditions. IOC orders are designed to be executed as quickly as possible. Any portion of an IOC order that cannot be filled immediately is canceled, unlike good-on-close orders, which are held until the market close.

The primary objective of an IOC order is to ensure rapid execution, making it suitable for traders who prioritize speed and are willing to forego a portion of their order to avoid adverse price movements. This contrasts with the objective of good-on-close orders, which is to capture the closing price of a security.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (g) Compare execution, validity, and clearing instructions.

Q.1130 Which of the following is *least likely* one of the three main functions of a financial system?

A. To allocate capital to its most effective uses.

B. To help people achieve their purposes in using the financial system.

C. To facilitate the discovery of the rate of return where aggregate savings equal aggregate borrowings.

The correct answer is **A.**

The three primary functions of a financial system are:

1. To help people achieve their purpose in using the financial
2. To facilitate the discovery of the rate of return where aggregate savings equal aggregate borrowings.
3. To allocate capital to its most efficient uses. A financial system allocates capital to its most EFFICIENT, not its most effective uses.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (a) Explain the main functions of the financial system.

Q.1131 Which of these agents provide brokerage services to large traders?

A. Block Brokers.

B. Trade Brokers.

C. Large Enterprise Brokers.

The correct answer is **A.**

Block Brokers specialize in handling large trades that may not be easily accommodated in the regular market due to their size. These trades often involve a significant number of shares that, if executed in the open market all at once, could significantly impact the stock's price. Block Brokers have the expertise and network to discreetly find counterparties for these large transactions, minimizing market impact and securing the best possible terms for their clients.

This service is crucial for institutional investors and other large traders who need to execute substantial orders without adversely affecting market prices. By providing a platform where large blocks of shares can be traded privately, Block Brokers facilitate liquidity and efficiency in the financial markets for these large transactions.

B is incorrect. Trade Brokers generally refer to a broader category of brokers who facilitate buying and selling securities for clients but do not specifically focus on large trades. While they may handle transactions of various sizes, they do not specialize in the unique challenges and strategies associated with executing large orders that Block Brokers do.

C is incorrect. The term Large Enterprise Brokers implies a large corporations or enterprises, but it does not accurately reflect the specialized role of brokers who manage large, individual trades in the market.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (d) Describe types of financial intermediaries and services that they provide.

Q.1630 Which of the following is *least likely* a function of the financial system?

A. Determine inflation rates.

B. Allocate capital efficiently.

C. Allow entities to save and borrow money

The correct answer is **A.**

The financial system plays a crucial role in the economy by facilitating the efficient allocation of resources, enabling savings and borrowing, and determining interest rates. However, the determination of inflation rates is primarily the outcome of broader economic activities and policies rather than a direct function of the financial system itself.

Inflation rates are influenced by factors such as monetary policy, supply and demand dynamics, and changes in the cost of goods and services. While the financial system can impact these factors indirectly through the influence of interest rates and credit availability, it does not directly set or determine inflation rates.

B is incorrect. Allocating capital efficiently is indeed a primary function of the financial system. The financial system facilitates the transfer of funds from savers, who have excess funds, to borrowers, who require funds for various purposes such as investment, consumption, or business expansion.

This allocation process is crucial for economic development and growth, as it ensures that resources are directed towards their most productive uses. Financial markets and institutions, including banks, stock markets, and bond markets, play a key role in this process by assessing the risk and return of different investment opportunities and making funds available to those with promising projects or needs.

C is incorrect. Allowing entities to save and borrow money is another fundamental function of the financial system. By providing a mechanism for savings, the financial system enables individuals, businesses, and governments to set aside funds for future use. Similarly, by offering various borrowing options, it allows these entities to access needed funds for immediate use, whether for consumption, investment, or operational purposes.

This function is essential for smoothing consumption over time, financing investment projects, and supporting economic activity and growth. Financial institutions such as banks, credit unions, and lending agencies are integral to this process, offering a range of saving and borrowing products to meet the diverse needs of the economy.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (a) Explain the main functions of the financial system.

Q.1631 When is a financial system *best* at performing its roles?

A. When the markets are illiquid.

B. When transaction costs are low.

C. When information is not readily available.

The correct answer is **B.**

A financial system is at its best performance when transaction costs are low. Low transaction costs mean that it is cheaper for investors to buy, sell, and trade assets. This efficiency encourages more trading and investment, which in turn increases liquidity and market participation.

Lower transaction costs also mean that a larger portion of an investment's return is retained by the investor, rather than being consumed by fees and other costs. This can lead to a healthier financial market with more active participants and a greater volume of transactions, contributing to the overall stability and efficiency of the financial system.

A is incorrect. Illiquid markets are not indicative of a financial system performing its roles effectively. Liquidity is a crucial aspect of a healthy financial system, as it ensures that assets can be quickly bought or sold in the market without causing a significant change in their price.

High liquidity facilitates the efficient allocation of resources and risk, enabling investors to easily enter and exit positions. Illiquid markets, on the other hand, can lead to higher transaction costs and may deter investment, thereby hindering the financial system's ability to support economic growth and stability.

C is incorrect. The availability of information is fundamental to the efficient functioning of financial markets. When information is readily available, it allows investors to make informed decisions, contributing to the proper pricing of assets and the efficient allocation of resources.

A lack of information, or information asymmetry, can lead to market failures such as moral hazard and adverse selection, which can undermine the integrity of the financial system and lead to inefficiencies. Therefore, a financial system performs best when information is transparent and accessible to all market participants.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (a) Explain the main functions of the financial system.

Q.1633 On which of the following markets do options and commodities *most* often trade?

A. Exchanges.

B. Real money market.

C. Over-the-counter (OTC) market.

The correct answer is **A.**

Options and commodities most often trade on exchanges. Exchanges, such as the Chicago Board of Trade (CBOT) for commodities and the Chicago Board Options Exchange (CBOE) for options, provide a centralized, regulated, and transparent platform for trading these financial instruments. These platforms ensure that trading is conducted in an orderly manner, with clear pricing information and standardized contract terms.

This structure helps in mitigating the risk of counterparty default and ensures fair trading practices. Furthermore, exchanges facilitate liquidity and price discovery, which are crucial for the efficient functioning of financial markets. By providing a venue where buyers and sellers can meet and trade based on current market information, exchanges play a vital role in the financial ecosystem.

B is incorrect. The real money market primarily deals with short-term debt instruments such as Treasury bills, commercial paper, and certificates of deposit, rather than options and commodities. These markets are characterized by high liquidity and low risk, focusing on instruments that have maturities of less than one year. While the real money market is crucial for short-term financing and investment, it does not typically facilitate the trading of options and commodities.

C is incorrect. While the Over-the-Counter (OTC) market does facilitate the trading of a wide variety of financial instruments, including derivatives and commodities, it is not the primary market for options and commodities trading. The OTC market is decentralized and consists of a network of dealers who trade directly with each other.

Although it offers flexibility in terms of contract customization and can accommodate instruments that may not meet the listing requirements of formal exchanges, the OTC market lacks the same level of regulation, transparency, and liquidity as exchanges. This can lead to higher counterparty risk and less efficient price discovery compared to exchange-traded options and commodities.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (j) Describe how securities, contracts, and currencies are traded in quote-driven, order-driven, and brokered markets.

Q.1634 Markets of immediate delivery are referred to as:

A. spot markets.

B. capital markets.

C. secondary markets.

The correct answer is **A.**

Spot markets are where transactions are settled immediately, or "on the spot," which means that the delivery of the asset or commodity traded occurs almost instantaneously upon execution of the trade. This characteristic distinguishes spot markets from other types of financial markets where settlement may occur at a future date.

In spot markets, the price agreed upon is known as the spot price, which is the current market price at which an asset can be bought or sold for immediate delivery. Spot markets are prevalent in commodities, foreign exchange, and securities trading, providing a mechanism for price discovery and immediate trade execution.

B is incorrect. Capital markets refer to the broad spectrum of tradeable assets that include long-term debt and equity instruments. Unlike spot markets, capital markets are primarily concerned with raising capital by dealing in shares, bonds, and other long-term investments.

These markets play a crucial role in the economy by facilitating the transfer of capital from investors to entities that need funding for various purposes, such as expansion, projects, or operations. The distinction between capital markets and spot markets lies in the nature of the assets traded and the immediacy of settlement. Capital markets focus on long-term securities that do not require immediate settlement, unlike transactions in spot markets.

C is incorrect. It highlights the role of secondary markets in providing liquidity and enabling price discovery for existing financial assets. Unlike spot markets, which are characterized by the immediate delivery of the asset being traded, secondary markets may involve assets that were issued at an earlier date and do not necessarily involve immediate settlement.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (b) Describe classifications of assets and markets.

Q.1636 Which of the following is *least likely* a type of fixed income securities?

A. Warrants.

B. Commercial paper.

C. Repurchase agreement.

The correct answer is **A.**

Warrants are financial derivatives that give the holder the right, but not the obligation, to buy a company's stock at a specified price before the warrant expires. Unlike fixed income securities, which provide investors with a regular income stream through interest payments, warrants are speculative instruments that depend on the underlying stock's price movements. They do not offer interest payments or guarantee a return, making them significantly different from traditional fixed income securities such as bonds or notes.

B is incorrect. Commercial paper is indeed a type of fixed income security. Commercial paper refers to short-term, unsecured promissory notes issued by corporations to finance their short-term liabilities, such as payroll or inventory costs. They typically have maturities of less than 270 days and offer a fixed interest rate to investors, making them an integral part of the money market and a fixed income instrument.

C is incorrect. Repurchase agreements, or repos, are also considered a form of fixed income security. In a repurchase agreement, one party sells a security to another party with an agreement to repurchase it at a later date for a higher price. The difference between the sale and repurchase price represents the interest. Repos are used for short-term borrowing and lending, often overnight, and are backed by collateral, usually in the form of government securities. This mechanism of secured lending and borrowing makes repurchase agreements a part of the fixed income securities landscape.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (c) Describe the major types of securities, currencies, contracts, commodities, and real assets that trade in organized markets, including their distinguishing characteristics and major subtypes.

Q.1637 John Dapper is an investor who has just purchased shares of Grande Investments, a pooled investment vehicle, on the New York Stock Exchange (NYSE). Grande Investments is *most likely*:

A. not a mutual fund.

B. an open-end mutual fund.

C. a closed-end mutual fund.

The correct answer is **C.**

Grande Investments, being a pooled investment vehicle that John Dapper has purchased shares of on the New York Stock Exchange (NYSE), is most likely a closed-end mutual fund. Closed-end mutual funds are distinct in their structure and operation compared to other types of investment funds. They are launched through an initial public offering (IPO) to raise capital, after which the shares are traded on a stock exchange similar to individual stocks.

This trading on the secondary market allows investors to buy and sell shares among themselves, with the market price of the shares being influenced by supply and demand dynamics. This characteristic is what distinguishes closed-end funds from open-end funds, as the latter do not trade on an exchange and are bought and sold at the net asset value (NAV) directly from the fund.

A is incorrect. Suggesting that Grande Investments is not a mutual fund overlooks the fact that it is described as a pooled investment vehicle. Mutual funds, whether open-end or closed-end, are types of pooled investment vehicles where investors' money is aggregated to invest in a diversified portfolio of securities. The key difference lies in how shares of the fund are bought and sold, not in the fundamental nature of being a mutual fund.

B is incorrect. Stating that Grande Investments is an open-end mutual fund contradicts the information that its shares were purchased on the NYSE. Open-end mutual funds do not trade on stock exchanges. Instead, their shares are issued and redeemed by the fund itself based on the NAV, which is calculated at the end of each trading day. Investors in open-end funds buy shares directly from the fund and sell them back to the fund, rather than trading them with other investors on an exchange.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (b) Describe classifications of assets and markets.

Q.1638 Which of the following funds have special provisions allowing the conversion of fund's shares into portfolio securities?

A. Hedge funds.

B. Mutual funds.

C. Exchange-traded funds.

The correct answer is **C.**

Exchange-traded funds (ETFs) have unique characteristics that distinguish them from other types of investment funds, one of which is the ability for investors to convert the fund's shares into a proportionate share of the underlying portfolio securities.

This feature is particularly beneficial for large institutional investors who may prefer to hold the actual securities for various reasons, including tax efficiency or specific investment mandates. The process, known as "in-kind" redemptions, allows these investors to avoid the potential capital gains taxes that could be triggered by selling shares of the ETF. This mechanism also helps to keep the ETF's share price closely aligned with its net asset value (NAV).

A is incorrect. Hedge funds are private investment vehicles that do not typically allow for the conversion of fund shares into portfolio securities. Hedge funds are known for their use of sophisticated strategies, including leverage, derivatives, and short selling. Investors in hedge funds usually have less liquidity than those in ETFs or mutual funds, with restrictions on withdrawals to certain periods, such as quarterly or annually.

The structure of hedge funds does not facilitate the direct exchange of shares for underlying securities, as their strategies and holdings are often complex and not transparent.

B is incorrect. Mutual funds, while offering a diversified portfolio like ETFs, do not allow investors to convert shares directly into the underlying portfolio securities. Mutual funds are structured to allow investors to buy and sell shares at the fund's NAV, calculated at the end of the trading day.

This structure does not support the "in-kind" redemptions feature that ETFs offer. Instead, when investors wish to redeem their shares, the mutual fund must sell securities to raise the necessary cash, a process that can potentially lead to capital gains distributions to the remaining investors and impact the fund's NAV.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (d) Describe types of financial intermediaries and services that they provide.

Q.1639 Which of the following statements regarding block brokers is *correct*?

A. Block brokers can place small orders.

B. Block brokers are involved in placing large orders.

C. Block brokers do not conceal the intentions of their clients which helps in moving the market.

The correct answer is **B.**

Block brokers specialize in handling large orders for their clients, which typically involve a significant number of shares. They play a crucial role in the financial markets by facilitating these large transactions in a manner that minimizes market impact. When a large order is placed in the market without any precautions, it can significantly affect the stock's price, either by driving it up if the order is to buy or pushing it down if the order is to sell.

Block brokers use various strategies, such as breaking down a large order into smaller ones and strategically timing these orders, to prevent such market movements. This approach helps in concealing the full extent of the transaction from the market until it is completed, thereby protecting the client's interests and preventing potential price manipulation by other market participants.

A is incorrect. While it is technically possible for block brokers to place small orders, this is not their primary function or area of specialization. Block brokers are specifically known for their ability to manage large orders in a way that minimizes their impact on the market. The statement does not accurately reflect the unique value proposition and expertise of block brokers, which lies in their handling of large, potentially market-moving orders.

C is incorrect. In reality, one of the key roles of block brokers is to precisely conceal these intentions to prevent adverse market movements. By strategically breaking down large orders and using other techniques, block brokers aim to mask the true size and direction of their clients' trades from the broader market.

This discretion is critical in ensuring that large orders do not lead to unfavorable price movements that could harm the client's interests. The statement contradicts the fundamental practices and objectives of block brokers in the financial markets.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (d) Describe types of financial intermediaries and services that they provide.

Q.1641 Which of the following traders will buy an asset from one market and sell it in another market without taking any risk?

A. An arbitrageur.

B. A broker-dealer.

C. A primary dealer.

The correct answer is **A.**

An arbitrageur is a trader who exploits price discrepancies between markets to make a profit without taking on risk. This strategy, known as arbitrage, involves simultaneously buying and selling an asset in different markets to take advantage of differing prices for the same asset. The key to arbitrage is that it is considered risk-free; the arbitrageur knows the prices in both markets beforehand and can execute the buy and sell orders at the same time, locking in a guaranteed profit.

This is possible due to inefficiencies in the markets that cause the same asset to be priced differently in two places. These inefficiencies can be due to a variety of factors, including differences in market liquidity, information availability, or even transaction costs.

B is incorrect. A broker-dealer acts as both a broker (buying and selling securities on behalf of clients) and a dealer (buying and selling securities for their own account). While broker-dealers play a crucial role in the financial markets by providing liquidity and facilitating transactions, their activities involve taking on risk.

As dealers, they hold inventory of securities and are exposed to the risk of price movements. As brokers, they may also face execution risk, where there is a risk that they cannot buy or sell a security at the quoted price due to rapid market movements. Therefore, unlike arbitrageurs, broker-dealers do not operate in a risk-free environment.

C is incorrect. A primary dealer is a type of financial institution, such as a bank or securities brokerage, that has been approved to trade securities directly with the government, typically in the context of government debt instruments. Primary dealers are an integral part of the government securities market, helping to underwrite new debt issues and provide a secondary market for these securities.

While primary dealers facilitate the smooth functioning of the government securities market and may engage in various trading strategies, they do not inherently buy and sell assets in different markets without taking any risk. Their activities can involve significant risk, including interest rate risk, credit risk, and market risk, depending on their positions and market conditions.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (d) Describe types of financial intermediaries and services that they provide.

Q.1642 Which one of these is *most likely* relevant example of a short-sell trade on a stock?

A. Sell the asset now with the obligation to repurchase it in the future.

B. Borrow and sell the asset now, with the obligation to buy back the asset in the future.

C. Buy a put option on the asset now with the right but not the obligation to repurchase the asset in the future.

The correct answer is **B.**

Option B accurately describes the process of a short-sell trade on a stock. In a short sale, an investor borrows shares of a stock from a broker and sells them on the open market at the current price. The investor's goal is to buy back the same number of shares at a lower price in the future, return the borrowed shares to the broker, and pocket the difference as profit.

This strategy is predicated on the belief that the stock's price will decline, allowing the investor to repurchase the shares at a lower cost. The obligation to buy back the asset in the future is a critical component of short selling, as it ensures that the borrowed shares are returned to the lender. This process involves a high level of risk, as the potential for loss is theoretically unlimited if the stock's price rises instead of falls.

A is incorrect. While option A mentions selling the asset now with the obligation to repurchase it in the future, it omits the crucial detail of borrowing the asset before selling it. In financial markets, you cannot sell what you do not own unless you have first borrowed it.

This distinction is fundamental to the concept of short selling, which specifically involves the sale of borrowed securities. The act of borrowing before selling is what differentiates short selling from other trading strategies and is essential for understanding the mechanics and risks associated with short positions in the stock market.

C is incorrect. Buying a put option on an asset gives the holder the right, but not the obligation, to sell the underlying asset at a predetermined price before the option expires. This strategy can be used to speculate on the decline of an asset's price or to hedge against potential losses in a long position. However, it does not involve borrowing and selling the asset, which is the defining characteristic of a short sale.

While holding a put option may reflect a bearish outlook similar to that of a short seller, the mechanisms, risks, and potential outcomes of these two strategies are distinct. A put option involves paying a premium for the right to sell, and the maximum loss is limited to this premium, unlike in short selling, where the potential for loss can be much greater.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (e) Compare positions an investor can take in an asset.

Q.1643 A trade in which an investor borrows funds from a broker to buy assets is called a:

A. long position.

B. short position.

C. leveraged position.

The correct answer is **C.**

A leveraged position occurs when an investor borrows money to finance the purchase of assets. This strategy allows the investor to increase the potential return on investment by using borrowed funds to gain a larger exposure to a particular asset than would be possible using only their own funds.

The cost of borrowing these funds is typically represented by the call money rate, which is the interest rate paid on the borrowed funds. Leveraging can amplify both gains and losses, making it a higher-risk investment strategy that relies on the assumption that the returns from the investment will exceed the cost of borrowing.

A is incorrect. A long position refers to the purchase of an asset with the expectation that its value will increase over time. When an investor takes a long position, they are essentially expressing confidence in the asset's future performance, hoping to sell it at a higher price than the purchase price.

This concept is fundamentally different from leveraging, as taking a long position does not inherently involve borrowing funds to finance the purchase. Instead, it simply means owning an asset outright, with the investor's capital at risk being limited to the amount invested.

B is incorrect. A short position involves borrowing an asset, typically securities, from a broker and selling it on the open market at its current price. The investor then aims to buy back the same number of shares or assets at a lower price in the future, return them to the lender, and pocket the difference as profit.

This strategy is predicated on the expectation that the asset's price will decline, allowing the investor to profit from the decrease in value. Unlike a leveraged position, which involves borrowing money to buy assets, a short position involves borrowing the assets themselves with the intention of profiting from a fall in their price. This distinction highlights the different risk and return profiles associated with short selling compared to leveraging.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (f) Calculate and interpret the leverage ratio, the rate of return on a margin transaction, and the security price at which the investor would receive a margin call.

Q.1644 Muhammad Umar is a fund manager who wants to purchase 5,000 stocks of Wellington Inc. at the current price of $92. If the initial margin required to open up a leveraged position is 35%, the leverage ratio is *closest to*:

A. 2.86

B. 3.10

C. 4.45

The correct answer is **A.**

The leverage ratio can be calculated by taking the inverse of the initial margin requirement. The initial margin is the percentage of the investment's total value that must be covered with the investor's own money.

The leverage ratio is calculated as:

$$\text{Leverage ratio} = \frac{1}{0.35} = 2.86$$

This calculation shows that for every dollar of equity, the investor is borrowing approximately $2.86.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (f) Calculate and interpret the leverage ratio, the rate of return on a margin transaction, and the security price at which the investor would receive a margin call.

Q.3591 An investment bank offers its customers the option to carry out leveraged trades. If the investors are required to maintain a margin of 20% and pay a commission of 0.25% of the trade value, then the leverage ratio for the trade is *closest to*:

A. 4.94.

B. 5.

C. 5.06.

The correct answer is **B.**

The leverage ratio for a trade is determined by the inverse of the margin requirement. In this case, with a margin requirement of 20%, the leverage ratio can be calculated as follows:

$$\begin{aligned}\text{Leverage ratio} &= \frac{1}{\text{Margin requirement}}\\ &= \frac{1}{20\%}\\ &= 5\end{aligned}$$

This calculation does not directly incorporate the commission of 0.25% of the trade value, as the commission affects the cost of the trade rather than the leverage ratio itself. The leverage ratio essentially indicates how much an investor can borrow to make a trade, relative to their own capital.

A 20% margin requirement means that the investor must provide at least 20% of the total trade value, allowing them to leverage or borrow up to 5 times their own investment.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (f) Calculate and interpret the leverage ratio, the rate of return on a margin transaction, and the security price at which the investor would receive a margin call.

Q.3592 An investment bank offers its customers the option to carry out leveraged trades. The investors must maintain a margin of 30% and pay a commission of 0.25% of the trade value. If an investor intends to carry out a trade of 2,000 shares, each with a price per share of $30, the total investment required for the trade is *closest to*:

A. $17,850.

B. $18,150.

C. $42,150.

The correct answer is **B.**

To calculate the total investment required for the trade, we must consider both the margin requirement and the commission fee. The margin requirement is a percentage of the total value of the trade that the investor must have in their account to open the position. The commission is a fee charged by the brokerage firm for executing the trade. In this scenario, the margin requirement is 30%, and the commission is 0.25% of the trade value.

$$\begin{aligned} \text{Total funds required to acquire the shares} &= 2,000 \times \$30 \\ &= \$60,000 \\ \text{Margin required for the trade} &= \$60,000 \times 30\% \\ &= \$18,000 \\ \text{Commission} &= \$60,000 \times 0.25\% \\ &= \$150 \\ \text{Total investment required for the trade} &= \$18,000 + \$150 \\ &= \$18,150 \end{aligned}$$

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (f) Calculate and interpret the leverage ratio, the rate of return on a margin transaction, and the security price at which the investor would receive a margin call.

Q.3594 An equity investor is bullish on a particular stock. He buys 20 futures contracts on the stock currently trading at $40/share on full margin. The broker requires its clients to maintain an initial margin of 35% and a maintenance margin of 25%.
If one futures contract equals 1,000 shares, then the maximum share price at which the margin call will get triggered is *closest to*:

A. $34.66.

B. $36.

C. $37.

The correct answer is **A.**

To determine the maximum share price at which a margin call will be triggered for an equity investor who has bought futures contracts on margin, we need to understand the concept of margin requirements in futures trading. The initial margin is the percentage of the purchase price that must be paid upfront, and the maintenance margin is the minimum account balance that must be maintained. If the account balance falls below this level, a margin call is triggered, requiring the investor to deposit additional funds to bring the account balance back up to the initial margin level.

Margin call price on a long position = $p_0\left(\frac{1-\text{initial margin}}{1-\text{maintenance margin}}\right)$

where p_0 is the initial price of the stock.

Margin call price = $40\left(\frac{1-0.35}{1-0.25}\right) = \$34.66$

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (f) Calculate and interpret the leverage ratio, the rate of return on a margin transaction, and the security price at which the investor would receive a margin call.

Q.3595 A trader has purchased 2000 shares of a non-dividend-paying firm on margin at a price of \$80 per share. The leverage ratio is 2.5. Six months later, the trader sells these shares at \$90 per share. Ignoring the interest paid on the borrowed amount and the transaction costs, the return to the trader during the six months is *closest to*:

A. 12.5%

B. 15%

C. 31.25%

The correct answer is **C.**

The return is 31.25 percent. If the position had been unleveraged, the return would be 12.5% = $\frac{(90-80)}{80}$. Because of leverage, the return is 31.25% = $2.5 \times 12.5\%$.
We can also look at it from the following perspective: the equity contributed by the trader (the minimum margin requirement) is $40\% = 100\% \div 2.5$. The trader contributed \$32 = 40% of \$80 per share. The gain is \$10 per share, resulting in a return of 31.25% = $\frac{10}{32}$.

We can also look at it in the perspective below.

$$\text{Max leverage ratio} = \frac{1}{\text{Initial margin requirement}} = \frac{1}{2.5} = 0.4$$

Therefore, the amount contributed by the trader for the purchase of the 2,000 shares is

$$0.4 \times (2000 \times 80) = 64,000$$

Gain from the sale of shares

$$= 2,000 \times (90 - 80) = 20,000$$

The return

$$\frac{20,000}{64,000} = 0.3125$$

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (f) describe the major types of securities, currencies, contracts, commodities, and real assets that trade in organized markets, including their distinguishing characteristics and major subtypes.

Q.3596 An equity analyst tracks the Information Technology (IT) sector. His analysis indicates that Value Information Technology Limited has excellent growth prospects. However, he concludes that its shares are currently slightly overvalued. If the analyst wants to buy the shares, he is *most likely* to place a:

A. limit order.

B. market order.

C. immediate or cancel order.

The correct answer is **A.**

Placing a limit order is the most suitable action for an equity analyst who believes that the shares of Value Information Technology Limited are currently overvalued but has excellent growth prospects. A limit order allows the analyst to specify a maximum purchase price for the shares, ensuring that he does not pay more than he believes the shares are worth. This strategy is particularly effective in situations where the analyst expects the market price of the shares to decrease to a more reasonable level in the future.

By setting a limit order, the analyst can potentially buy the shares at a lower price, aligning with his valuation and growth prospects assessment. This approach demonstrates a prudent and strategic method of investing, where the analyst's in-depth analysis and valuation guide the decision-making process, ensuring investments are made at favorable prices.

B is incorrect. Accepting the sell order without informing the client about the recent change in the firm's recommendation would not align with the ethical standards of fair dealing. This approach would disregard the importance of ensuring that the client's decisions are based on the most current and relevant information. In the dynamic and often volatile investment landscape, recommendations can change rapidly based on new data or market developments. Failing to communicate these changes before executing a sell order could lead to the client making a less informed decision, potentially affecting their investment outcomes negatively.

C is incorrect. It is contrary to the firm's recommendation and would not be in the best interest of the client. Investment professionals are required to act in their clients' best interests, providing them with objective advice and respecting their autonomy in decision-making. By refusing to execute the order based on the firm's current recommendation, the professional would be prioritizing the firm's interests over the client's, which is contrary to the principles of fairness and objectivity in investment management.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (h) Compare market orders with limit orders.

Q.3597 The market price and net asset value of ETFs converge because:

A. ETFs are open-end funds.

B. Authorized participants have the option to trade directly with the ETF.

C. Authorized participants can redeem ETFs from the fund at the market price.

The correct answer is **B.**

The convergence of the market price and net asset value (NAV) of Exchange-Traded Funds (ETFs) is primarily facilitated by the role of Authorized Participants (APs). APs are typically large financial institutions that have the ability to trade directly with the ETF. This unique mechanism allows APs to create or redeem shares of the ETF in exchange for the underlying assets. When the market price of an ETF deviates from its NAV, APs can arbitrage the difference, thus bringing the prices back into alignment.

For instance, if the market price of an ETF is higher than its NAV, APs can purchase the underlying assets, exchange them for new ETF shares, and sell those shares at the higher market price. Conversely, if the market price is below the NAV, APs can buy ETF shares in the market and redeem them with the ETF for the underlying assets, which they can then sell. This process ensures that the market price of ETF shares does not stray significantly from the NAV over time.

A is incorrect. ETFs are not open-end funds; they are structured as open-end investment companies but trade on exchanges like stocks. The primary distinction lies in how shares are traded. Open-end funds do not have their shares traded on the open market, and their NAV is calculated at the end of each trading day. In contrast, ETFs trade throughout the trading day at market prices that can fluctuate. This trading characteristic of ETFs does not directly contribute to the convergence of market price and NAV.

C is incorrect. While it is true that Authorized Participants can redeem ETF shares, they do so at the NAV, not at the market price. The ability to redeem at the NAV is crucial for the arbitrage mechanism that helps keep the ETF's market price in line with its NAV. If APs were to redeem at the market price, this would not necessarily encourage the alignment of the two prices, as the arbitrage opportunity relies on the difference between the market price and the NAV.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (c) Describe the major types of securities, currencies, contracts, commodities, and real assets that trade in organized markets, including their distinguishing characteristics and major subtypes.

Q.3598 Which of the following financial instruments is *least likely* traded in an exchange market?

A. Options.

B. Futures.

C. Forwards.

The correct answer is **C.**

Forwards are financial instruments that are least likely to be traded on an exchange market. Forward contracts are agreements to buy or sell an asset at a specified future time at a price agreed upon today. Unlike futures and options, forwards are typically customized contracts between two parties and are traded over-the-counter (OTC).

This customization allows for specific terms to be negotiated directly between the buyer and seller, including the quantity of the asset and the settlement date. However, this direct negotiation and lack of standardization mean that forwards do not benefit from the liquidity and transparency provided by exchange markets. Furthermore, the OTC nature of forwards introduces counterparty risk, as there is no central clearinghouse to guarantee the performance of the contract.

A is incorrect. Options are financial derivatives that give the buyer the right, but not the obligation, to buy (in the case of a call option) or sell (in the case of a put option) an underlying asset at a specified price on or before a certain date.

Options are widely traded on various exchanges, providing liquidity, transparency, and reduced counterparty risk due to the presence of a clearinghouse that guarantees the contracts. The standardized nature of exchange-traded options facilitates ease of trading and valuation, making them popular instruments among investors.

B is incorrect. Futures are standardized contracts to buy or sell a specific quantity of a commodity or financial instrument at a predetermined price at a specified time in the future. Like options, futures contracts are traded on exchanges, which provide a regulated and transparent marketplace for these instruments.

The standardization of futures contracts, along with the presence of a clearinghouse, reduces counterparty risk and increases liquidity, making futures a popular choice for hedging, speculating, and arbitrage opportunities. The exchange-traded nature of futures contracts ensures that prices are publicly available, contributing to market transparency and efficiency.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (c) Describe the major types of securities, currencies, contracts, commodities, and real assets that trade in organized markets, including their distinguishing characteristics and major subtypes.

Q.3599 Financial intermediaries securitize assets by creating Special Purpose Vehicles (SPVs) because:

A. it increases overall return.

B. SPVs decrease the liquidity of securitized assets.

C. it protects the SPV in case the financial intermediary goes bankrupt.

The correct answer is **C.**

Creating Special Purpose Vehicles (SPVs) for the securitization of assets is a strategic move by financial intermediaries to ensure that the assets are legally and financially insulated from the parent company, particularly in the event of bankruptcy.

The primary rationale behind this strategy is to safeguard the interests of investors by ensuring that the assets held within the SPV are not accessible to the creditors of the parent company should it face financial distress. This legal separation enhances the security of the investment, making it more attractive to potential investors who are assured that their investments are protected against the bankruptcy risks of the originating financial intermediary.

A is incorrect. While it might seem intuitive that creating SPVs could lead to an increase in overall return due to the potential for risk segmentation and the creation of new financial products, this is not the primary purpose or a guaranteed outcome of SPV creation.

The establishment of an SPV is primarily a legal and financial structuring decision aimed at asset protection and bankruptcy remoteness, rather than directly aiming to enhance returns. The returns on investments in securitized assets are influenced by a variety of factors including the performance of the underlying assets, market conditions, and investor demand, rather than the mere existence of an SPV.

B is incorrect. Contrary to decreasing the liquidity of securitized assets, SPVs often play a crucial role in enhancing the liquidity of these assets. By pooling various types of assets and issuing securities that are backed by these asset pools, SPVs transform otherwise illiquid assets into securities that can be more easily traded in the financial markets.

This process not only broadens the investor base by catering to different risk and return preferences through the creation of various tranches of securities but also enhances the overall liquidity of the underlying assets. The increased liquidity is beneficial for both the original asset owners, who can more easily finance their operations, and for investors, who gain access to a wider range of investment opportunities with varying risk and return profiles.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (d) describe types of financial intermediaries and services that they provide.

Q.3600 An investor places an ‘immediate or cancel’ sell order for 20 contracts at a limit price of $41.50. The current pending orders in the market are given in the following exhibit.

Exhibit 1: Pending orders

Counterparty	Contract size	BUY/SELL ORDER	Price
A	10	BUY	$41.00
B	5	BUY	$42.00
C	10	BUY	$43.00
D	5	SELL	$44.00
E	5	SELL	$45.00
F	10	SELL	$46.00

The number of contracts that get filled and the average trade price, respectively, are *closest to*:

A. Number of contracts = 15, Average trade price = $42.33.

B. Number of contracts =20, Average trade price = $42.25.

C. Number of contracts =15, Average trade price = $42.67.

The correct answer is **C.**

The sell order is filled with the counterparty, which offers the highest 'buy price'.

Contract	Price	Offered By
10	$43.00	C
5	$42.00	B

As the price offered by A is below $41.50, no more order gets filled. As the order placed by the investor is an 'immediate or cancel' order, the unfilled contracts, i.e., five contracts, are canceled immediately in the absence of any favorable quotes.
Number of contracts filled = 15

Average trade price $= \frac{\$43 \times 10 + \$42 \times 5}{15} = \$42.67$

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (j) describe how securities, contracts, and currencies are traded in quote-driven, order-driven, and brokered markets.

Q.3601 If a currency transaction is carried out on Wednesday, September 8th, 2017, then the trade settlement will *most likely* happen on:

A. September 9th, 2017.

B. September 10th, 2017.

C. September 11th, 2017.

The correct answer is **B.**

The standard settlement timeframe for foreign exchange (FX) spot transactions is T+2, meaning two business days from the trade date. Given that the currency transaction in question was carried out on Wednesday, September 8th, 2017, the settlement would most likely happen on Friday, September 10th, 2017.

This is because the T+2 settlement rule applies to business days, excluding weekends and public holidays. Therefore, counting two business days from Wednesday brings us to Friday of the same week, assuming there are no public holidays in between.

A is incorrect. This option suggests that the settlement would occur on September 9th, 2017, which is only one business day after the transaction. This does not comply with the T+2 settlement rule applicable to FX spot transactions.

C is incorrect. It includes a weekend. The T+2 rule specifies two business days, and since weekends are not considered business days, this option extends beyond the standard settlement period for an FX spot transaction conducted on a Wednesday.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (g) Compare execution, validity, and clearing instructions.

Q.3602 An oil producer is worried that the price of crude oil may soon decrease. To hedge his risk, the crude oil producer must:

A. buy a futures crude oil contract.

B. sell a forward crude oil contract.

C. buy a forward crude oil contract.

The correct answer is **B.**

To hedge against the potential decrease in crude oil prices, the oil producer should opt to sell a forward crude oil contract. This strategy allows the producer to lock in a selling price for the oil at today's rates, thereby securing a guaranteed price at which they can sell their oil in the future, regardless of potential market price declines.

Selling a forward contract serves as a financial hedge, providing the producer with a form of insurance against falling prices. By entering into this contract, the producer agrees to sell a specified amount of oil at a predetermined price at a future date. This move is prudent for producers who are concerned about price drops that could reduce their revenue. By locking in a price now, they can ensure a certain level of income, making their financial planning more predictable and secure.

A is incorrect. Buying a futures crude oil contract would not serve the oil producer's goal of hedging against a price decrease. Futures contracts, like forward contracts, allow for the purchase or sale of an asset at a future date, but they are standardized and traded on exchanges. If the producer buys a futures contract, they are committing to purchasing oil at a set price in the future, which is counterproductive when their objective is to sell oil at today's price to hedge against a potential decrease.

This action would expose the producer to the risk of having to buy oil at a potentially higher price than the market rate at the time of the contract's execution, which does not align with the goal of mitigating the risk of falling oil prices.

C is incorrect. Buying a forward crude oil contract implies that the producer intends to purchase oil at a predetermined price in the future, which is not the producer's intention. Producers who anticipate a decrease in oil prices would not look to buy more oil at today's prices; instead, they aim to sell their existing or future oil production at current prices to avoid the risk of selling at lower prices later.

Buying a forward contract would be a strategy used by consumers or companies that need to secure a supply of oil at a known price to manage their costs, not by producers looking to hedge against price declines.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (c) Describe the major types of securities, currencies, contracts, commodities, and real assets that trade in organized markets, including their distinguishing characteristics and major subtypes.

Q.3603 A currency trader wants to sell the Australian dollar against the US dollar. He requested a quote from a dealer and received the quote as indicated in Exhibit 1.

Exhibit 1: AUD/USD Quote

AUD/USD	0.776/0.779

The rate at which the trader will sell the Australian dollar to the dealer is *closest to*:

A. 0.7760.

B. 0.7775.

C. 0.7790.

The correct answer is **A.**

A market maker provides two quotes for currency trades – the bid and the ask. The 'bid' price is the price at which the market maker is willing to buy the currency, and the 'ask' is the price at which the market maker is willing to sell the currency. Therefore, the currency trader will sell the Australian dollar at 0.7760.
Note: The bid is always lower than the ask and is always the first quoted price. A trader will sell at the bid price and buy at the ask price.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (g) Compare execution, validity, and clearing instructions.

Q.3604 The main advantage of issuing shares through shelf registration is:

A. it lowers transaction costs.

B. it allows corporations the flexibility to issue shares when required.

C. it allows unreliable corporations to issue shares in the secondary market.

The correct answer is **B.**

Shelf registration provides corporations with the flexibility to issue shares when required, which is a significant advantage in dynamic financial markets. This method allows companies to register securities without having to immediately sell them. Instead, the registered securities can be sold in portions within a three-year period following the initial registration.

This flexibility is crucial for corporations as it enables them to respond quickly to favorable market conditions or capital needs without undergoing the lengthy process of a new registration each time. By having the ability to issue shares at opportune times, companies can optimize their capital structure and funding strategies more efficiently.

A is incorrect. While it might seem that shelf registration could lower transaction costs due to its streamlined process, this is not its primary advantage. The main purpose of shelf registration is to provide flexibility in timing and amount of the securities to be issued.

Although there might be some cost savings in terms of reduced legal and underwriting fees over time, these are not the primary focus or the main advantage of shelf registration. The process still incurs significant costs, including those associated with SEC review and compliance, making the reduction of transaction costs a secondary benefit rather than a primary advantage.

C is incorrect. Shelf registration is not designed to allow unreliable corporations to issue shares in the secondary market. In fact, the ability to use shelf registration is typically limited to issuers that meet specific regulatory criteria, demonstrating their reliability and compliance with securities laws.

Regulatory authorities, such as the Securities and Exchange Commission (SEC) in the United States, require issuers to meet certain standards, including a history of timely financial reporting and adherence to governance standards. This ensures that only companies deemed reliable and transparent by the regulatory authority can take advantage of shelf registration. The misconception that it allows unreliable corporations to issue shares overlooks the stringent regulatory requirements and oversight involved in the shelf registration process.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (i) Define primary and secondary markets and explain how secondary markets support primary markets.

Q.3605 Which of the following statements is/are *most likely* accurate?

I. In a ‘best effort offering,’ the underwriters buy an issue and use their best effort to sell the issue to investors.
II. In an ‘underwritten offering,’ the underwriters buy an issue and then attempt to sell the issue to investors.
III. A ‘best effort offering’ is the most common type of offering.

A. II

B. I & III

C. II & III

The correct answer is **A.**

Statement II accurately describes an 'underwritten offering,' where the underwriters purchase the issue from the issuer and then attempt to sell it to investors. This process involves a significant commitment from the underwriter, as they assume the risk of buying the securities and potentially not selling them at a profit.

The underwriter's profit comes from the spread between the price paid to the issuer and the price at which the securities are sold to investors. This method is commonly used because it provides the issuer with a guaranteed amount of capital from the sale of the securities, making it a preferred choice for many issuers.

B is incorrect. Statement I misrepresents the nature of a 'best effort offering.' In this type of offering, underwriters agree to sell as much of the issue as possible, but they do not commit to purchasing the entire issue themselves. Instead, they act as agents for the issuer, using their best efforts to sell the securities to investors.

There is no guarantee to the issuer of how much capital will be raised, as the underwriters do not assume the risk of buying unsold shares. This arrangement is less risky for underwriters compared to an underwritten offering, as they are not obligated to purchase any unsold securities.

C is incorrect. Statement III incorrectly identifies a 'best effort offering' as the most common type of offering. In reality, 'underwritten offerings' are more prevalent in the market. Underwritten offerings provide issuers with a certain degree of financial security by ensuring a specific amount of capital will be raised, assuming the underwriter can sell the securities. This guarantee is attractive to many issuers, making underwritten offerings a more common choice compared to best effort offerings, where the amount of capital raised can be uncertain.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (i) Define primary and secondary markets and explain how secondary markets support primary markets.

Q.3606 Michael Bugatti, a large Wall Street bank trader, wants to buy 500,000 shares of apples right before Q4 earnings. However, he is afraid that high-frequency algorithms might front-run him and offer slightly higher prices than his large order. To avoid this, Bugatti can *most likely* use a/an:

A. iceberg order.

B. all-or-nothing order.

C. good-till-canceled order.

The correct answer is **A.**

A large lot is broken into smaller-sized orders in an iceberg order to hide the actual order quantity. The smaller parts are either visible or hidden, with the latter becoming visible after the former order has been executed. The entire order size is not displayed using an iceberg order, thereby preventing other traders/dealers/algorithms from quoting higher prices.
B is incorrect. In an all-or-nothing order, the order has to be either filled or canceled. Partial fills are not allowed.

C is incorrect. In a good till canceled order, the order is open for trade up until it is canceled.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (g) Compare execution, validity, and clearing instructions.

Q.3607 A technical analyst has 100 shares of LOLO, which are currently trading at $40.32. The chart structure indicates that once the share price crosses the $50.58 mark, the share price is expected to reach $71.86. If the technical analyst wants to purchase 100 more shares of LOLO once its price reaches $50.58, then he must *most likely* use a:

A. market order.

B. stop buy order at $50.58.

C. limit buy order at $50.58.

The correct answer is **B.**

A technical analyst looking to purchase 100 more shares of LOLO once its price reaches $50.58 should use a stop buy order at $50.58. A stop buy order is specifically designed to be executed at a specified price or better after a given stop price has been reached or passed.

This type of order is particularly useful for traders who wish to enter the market at a price above the current market price, anticipating that the stock's price will continue to rise once it crosses a certain threshold. In this scenario, setting a stop buy order at $50.58 ensures that the order will only be executed if the stock price reaches or exceeds $50.58, aligning with the analyst's strategy based on the chart structure's indication.

A is incorrect. A market order is an order to buy or sell a security immediately at the best available current price. It does not specify a price and thus offers no control over the entry price. In the context of the analyst's strategy, using a market order would result in the immediate purchase of the shares at the current market price of $40.32, which does not align with the intention to buy at or above $50.58 based on the technical analysis.

C is incorrect. A limit buy order at $50.58 would instruct the broker to buy the stock only at $50.58 or lower. This type of order is used when the buyer is looking to purchase a stock at a specific price or better, ensuring that they do not pay more than a certain price.

However, in the scenario described, the analyst's strategy is to buy the stock specifically as it rises to $50.58, indicating a bullish outlook that expects the stock price to increase further beyond this point. A limit buy order at $50.58 could potentially not be executed if the stock price surpasses $50.58 without retracing back to that exact price or lower, thus not aligning with the analyst's intended strategy based on the chart structure's predictions.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (g) Compare execution, validity, and clearing instructions.

Q.3867 The segregated cash flows from securitized assets are called:

A. Tranches

B. Dark pools

C. Special purpose entities

The correct answer is **A.**

Tranches are the segregated cash flows from securitized assets, which are essentially slices or portions of a financial product that can be sold to investors. The concept of tranches is particularly prevalent in the context of structured finance and securitization, where a pool of financial assets—such as mortgages, loans, or bonds—is divided into various segments based on risk, maturity, or other characteristics.

This segmentation allows investors to select parts of the financial product that best match their risk tolerance, investment horizon, and return objectives. By investing in different tranches, investors can tailor their investment portfolios according to their specific preferences and needs. The structuring of tranches enables the creation of securities with varying degrees of risk and return, making it possible to attract a broader range of investors. This diversification of risk and customization of investment options are key reasons why tranches are a critical component of securitized assets.

B is incorrect. Dark pools refer to private financial forums or exchanges for trading securities, primarily stocks, where the transactions are executed away from the public eye. The primary characteristic of dark pools is their lack of transparency, as the details of the trades, such as the identities of the traders and the exact trade sizes, are not disclosed until after the transactions have been completed. Dark pools are more about the venue and manner of trading rather than the structuring of financial products.

C is incorrect. Special Purpose Entities (SPEs) are legal entities created for a specific objective, often to isolate financial risk. SPEs are commonly used in complex financial transactions, including securitizations, to separate certain assets and liabilities from the parent company.

While SPEs play a crucial role in the securitization process by holding the assets being securitized, the term itself does not refer to the segregated cash flows from these assets. Instead, SPEs serve as the structural foundation that holds the assets and issues the tranches of securities to investors. Therefore, this option does not accurately describe the segregated cash flows from securitized assets.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (c) Describe the major types of securities, currencies, contracts, commodities, and real assets that trade in organized markets, including their distinguishing characteristics and major subtypes.

Q.3870 What is a *most likely* benefit of a corporation issuing new securities in a private placement instead of an initial public offering?

A. Lower cost of capital.

B. Cheaper offering costs.

C. More liquidity for investors.

The correct answer is **B.**

Issuing new securities through a private placement instead of an initial public offering (IPO) offers the benefit of cheaper offering costs for the corporation. Private placements are transactions made directly between the issuer and a select group of investors, typically institutional or accredited investors. This method is less costly because it involves fewer regulatory requirements and lower underwriting fees compared to an IPO.

The Securities and Exchange Commission (SEC) imposes stringent disclosure and registration requirements on companies looking to go public through an IPO, which can significantly increase the costs associated with the offering. Additionally, marketing and roadshow expenses in an IPO can further escalate the total costs. In contrast, a private placement bypasses many of these expenses, making it a more cost-effective way for companies to raise capital.

A is incorrect. Securities issued in a private placement are typically less liquid and sold to a smaller pool of investors, these investors may demand a higher return on their investment to compensate for the additional risk and lower liquidity. This can lead to a higher cost of capital for the issuer compared to securities issued in an IPO, where the potential for greater liquidity and a larger pool of investors can lead to more competitive pricing and potentially lower the cost of capital.

C is incorrect. More liquidity for investors is not a benefit associated with private placements. Liquidity refers to the ease with which securities can be bought or sold in the market without affecting their price. Securities issued in a private placement are generally not traded on public exchanges and are subject to transfer restrictions, making them less liquid than securities issued in an IPO.

IPOs allow companies to list their shares on public exchanges, where they can be bought and sold by a wide range of investors, thereby providing greater liquidity. In contrast, the limited pool of investors and the restrictions on the transfer of privately placed securities result in lower liquidity for investors.

CFA Level 1, Topic 6 - Equity Investments, Learning Module 1: Market Organization and Structure, LOS (i) Define primary and secondary markets and explain how secondary markets support primary markets.