Topic 30 to 34

Test ID: 8451002

Question #1 of 64

Question ID: 439061

Which of the following statements regarding orders in exchange markets is *least* accurate?

✓ **A)** **A stop buy order is an order to purchase a stock if the price falls to the stop price.**

✗ **B)** A limit sell order is an order to sell at a price greater than the limit price.

✗ **C)** In a short sale, a trader borrows stock and sells it.

✗ **D)** A stop buy order can be combined with a short sale to limit losses.

Explanation

A stop buy order is an order to buy a stock if the price *rises* to the stop price. This type of order is often used to limit losses on a short position. A limit buy order specifies a maximum price and a limit sell order specifies a minimum price.

Question #2 of 64

Question ID: 439007

Jerry Jacuire is a key member of an open outcry commodity exchange. Jacuire trades for others and earns a commission. Jacuire is most likely which type of exchange member?

✗ **A)** **Local.**

✗ **B)** Day trader.

✓ **C)** Floor broker.

✗ **D)** Scalper.

Explanation

Individuals who participate in exchange trading must be exchange members or possess trading privileges on the exchange. With regard to an open outcry (i.e., non-electronic) exchange system, key exchange members are as follows:

• Local: uses personal capital to trade for a personal account. Relies on short-term trading skills and market analysis. The local may use as many different trading styles as other traders.

• Scalper: trades frequently in an attempt to make money on small price movements.

• Day trader: trades frequently throughout the day, but has a zero (flat) net position at the end of the day.

• Floor broker: trades for others and earns a commission.

Question #3 of 64

Question ID: 439041

The initiation of a futures position:

✓ **A)** **requires both a buyer and a seller.**

✗ **B)** is done through a bank or other large financial institution acting as a dealer.

✗ **C)** is at a price negotiated between the buyer and seller.

✗ **D)** is often done with a futures dealer when the asset is not standard.

Explanation

Futures trades are done through open outcry on the futures exchange and require a buyer (long) and a seller (short) for a trade to take place. The other statements are generally true for forward contracts, which are all individually negotiated.

Question #4 of 64

Question ID: 439204

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

✓ **A)** **arbitrage.**

✗ **B)** the law of one price.

✗ **C)** exchange parity.

✗ **D)** payoff parity.

Explanation

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

Question #5 of 64

Question ID: 439198

Considering the differing needs and goals of spot buyers, hedgers, speculators and arbitrageurs, which of these parties have a primary goal of transferring the risk of price change?

✗ **A)** **Spot buyer.**

✗ **B)** Arbitrageur.

✓ **C)** Hedger.

✗ **D)** Speculator.

Explanation

The hedger transfers risk to the speculator, and the hedger is left only with the risk of a change in basis.

Question #6 of 64

Question ID: 439030

To equitize the cash portion of assets under management, a portfolio manager enters into a long futures position on the S&P 500 index with a multiplier of 250. The cash position is $15 million which at the current futures value of 1,000, requires the manager to be long 60 contracts. If the current initial margin is $12,500 per contract, and the current maintenance margin is $10,000 per contract, what variation margin does the portfolio manager have to advance if the futures contract value falls to 995 at the end of the first day of the position being placed?

✓ **A)** **$0.**

✗ **B)** $75,000.

✗ **C)** $30,000.

✗ **D)** $300,000.

Explanation

The futures contract ended at 995 on the first day. This represents a decrease in value in the position of 5 × 250 × 60 = $75,000. The initial margin placed by the manager was $12,500 * 60 = $750,000. The maintenance margin for this position requires $10,000 * 60 or $600,000. Since the value of the position declined $75,000 on the first day, the margin account is now worth $675,000, and will not require a variation margin to bring the position to the proper margin level.

Question #7 of 64

Question ID: 439029

Revaluing a participant's portfolio to market value at the end of each trading day describes which mechanism for reducing counterparty risk?

✗ **A)** **Downgrade triggers.**

✗ **B)** Netting.

✗ **C)** Contract standardization.

✓ **D)** Marking to market.

Explanation

Marking to market refers to revaluing a participant's portfolio to market value at the end of each trading day.

Question #8 of 64

Question ID: 439197

How are futures contracts typically organized and arranged?

✗ **A)** **Futures contracts are used to hedge commodity and financial product risk, are organized between two parties privately, and can be established in any quantity or product.**

✗ **B)** Futures contracts do not trade on organized exchanges, do not require margin deposits, and are not regulated by any agencies.

✗ **C)** One counterparty agrees to buy, and another counterparty agrees to sell, a given asset, at an agreed price, and there always exists risk that one party may default.

✓ **D)** Futures contracts require a margin deposit, the position is marked to market daily, and are standardized according to exchange guidelines.

Explanation

Futures contracts are standardized contracts which must follow guidelines set forth by the exchange. They do not have counterparty default risk, since the futures exchange clearinghouse guarantees each transaction.

Question #9 of 64

Question ID: 439023

If a risk manager misuses derivatives by speculating instead of actually hedging, what is the term for it?

✗ **A)** **Regulatory risk.**

✗ **B)** Catastrophic risk.

✗ **C)** Business risk.

✓ **D)** Operational risk.

Explanation

When a trader uses derivatives to speculate rather than hedge, it is known as operational risk to a company.

Question #10 of 64

Question ID: 439050

Which of the following statements about closing a futures position through delivery is *most* accurate?

✗ **A)** **Although the popularity of physical delivery has decreased over time, delivery by cash settlement remains the most popular method of closing a futures position.**

✗ **B)** Delivery is also known as *exchange for physicals* (EFP).

✗ **C)** Delivery can occur through the clearinghouse or by private party negotiation.

✓ **D)** Depending on the wording of the contract, a trader may close a contract by either delivering the goods to a designated location or by making a cash settlement of any gains or losses.

Explanation

The other statements are false.

Physical deliveries and cash settlements combined represent *less than one percent* of all settlements.

An *exchange for physicals differs* from a delivery in that:

- The traders actually exchange the goods.
- The contract is not closed on the floor of the exchange.
- The two traders privately negotiate the terms of the transaction.

An *offsetting, or reversing* trade occurs through the clearinghouse.

Question #11 of 64

Question ID: 439005

Which of the following statements is least accurate regarding the differences or similarities between futures contracts and equities?

✓ **A)** **Futures, like equities, are designed for capital formation.**

✗ **B)** Futures contracts have a finite time frame, whereas equities do not.

✗ **C)** Shorting is easier in the futures market than the equity markets.

✗ **D)** Futures contracts have no limit on the number on contracts issued, whereas equities have a limit on shares issued.

Explanation

Futures have many unique features and differ from forward contracts and equity securities in several different ways. Distinct differences between futures contracts and equities (i.e., stocks) are as follows:

• Futures markets are designed more for risk shifting and price discovery than capital formation. The equity market's main purpose is to assist in capital formation.

• Shorting is easier in the futures market than the equity market. There is a short for every long in the futures market; therefore, it is just as easy to take a short position as it is to take a long position. Shorting stock requires borrowing shares and other complications, such as payment of dividends.

• Futures contracts have a finite time frame, whereas equities do not.

• There are a finite number of shares issued on an individual stock at any point in time. There is no limit on the number of futures contracts that may exist at any point in time for a given commodity.

Question #12 of 64

Question ID: 439207

A futures contract is established for a farmer's wheat crop and the quantity and quality of the good is specified in the contract. The futures contract further specifies the time and place of delivery, as well as the permitted methods for closing the contract. What key role does the futures exchange serve?

✓ **A)** **Provides a location for price discovery.**

✗ **B)** Determines permissible price fluctuations but does not require daily settlements.

✗ **C)** Assists in bringing parties together, but does not guarantee delivery.

✗ **D)** Specifies each side of the contract's obligations and ensures proper delivery of commodity.

Explanation

Providing a location for price discovery is a key role that the futures exchange plays. 98% of futures contracts are actually offset so there is not physical delivery required.

Question #13 of 64

Question ID: 439059

Dan Chavez, FRM is long one contract at $1,610 per ounce of gold in the futures market. Gold has dropped to $1,575 per ounce. Chavez is trying to decide how to settle the position. If Chavez elects to reverse the position, how is the process best described?

✗ **A)** **Accept delivery of the goods and pay the contract price to the other side.**

✗ **B)** Gold contracts are cash-settlement contracts in which delivery is not an option. The futures accounts are marked to market at the end of the contract.

✓ **C)** The same contract is sold, and the difference of $35 per ounce is deducted from the trader's margin account.

✗ **D)** Find a trader with opposite position, deliver goods, and settle position off the floor of the exchange.

Explanation

An offsetting trade such as described is how most futures positions are settled. This effectively closes out the position, and the difference is deducted from Chavez's margin account.

Question #14 of 64

Question ID: 439057

Which of the following is *least likely* a way to terminate a long position in a deliverable futures contract at expiration?

- ✗ **A)** **An exchange-for-physicals.**
- ✗ **B)** Taking delivery.
- ✓ **C)** An equivalent cash settlement.
- ✗ **D)** Close-out at expiration.

Explanation

A deliverable contract does not permit equivalent cash settlement. Sale of an offsetting contract at the settlement price on the final day of trading (close-out at expiration) will have the same effect, with the cash settlement effectively taking place in the margin account.

Question #15 of 64

Question ID: 439011

An open outcry system of trading:

- ✗ **A)** **is considered a non-traditional trading system.**
- ✗ **B)** typically does not involve traders using hand signals.
- ✗ **C)** primarily involves computer based trading.
- ✓ **D)** involves a physical exchange location.

Explanation

An open outcry system is considered the traditional system with traders indicating trades through hand signals at a physical exchange.

Question #16 of 64

Question ID: 439056

An offsetting trade is used to:

- ✓ **A)** **close out a futures position prior to expiration.**
- ✗ **B)** speculate in the futures market.
- ✗ **C)** fully hedge a risk arising in the normal course of business activity.
- ✗ **D)** partially hedge the interest rate risk of a bond position.

Explanation

An offsetting/reversing trade is used to close out a futures position prior to expiration.

Question #17 of 64

Question ID: 439043

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

- ✓ **A)** **a deposit is required to return the account margin to the initial margin level.**
- ✗ **B)** a deposit is required which will bring the account to the maintenance margin level.
- ✗ **C)** a margin deposit equal to the maintenance margin is required within two business days.
- ✗ **D)** a margin deposit is required only if the price does not rise sufficiently the next (trading) day.

Explanation

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

Question #18 of 64

Question ID: 439025

What is the term for the difference between the spot price and the future price, and what happens to it as the futures contract approaches expiration?

- ✗ **A)** **Convergence; it decreases.**
- ✗ **B)** Spot arbitrage; it increases.
- ✓ **C)** Basis; it decreases.
- ✗ **D)** Spot different; it approaches zero.

Explanation

Basis = spot price - futures price

As maturity approaches, the basis converges to zero.

Question #19 of 64

Question ID: 439060

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

- ✗ **A)** **limit order to buy.**
- ✗ **B)** limit order to sell.
- ✗ **C)** stop order to sell.
- ✓ **D)** stop order to buy.

Explanation

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

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

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

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

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

Question #20 of 64

Question ID: 439210

An exchange-for-physicals, as it pertains to futures contracts:

✗ **A)** **is not permitted for financial futures.**

✗ **B)** is another term for accepting delivery of an asset to satisfy a futures contract.

✗ **C)** is another term for delivering an asset to satisfy a futures contract.

✓ **D)** involves an agreement off the floor of the exchange.

Explanation

An exchange-for-physicals involves an agreement between long and short contract holders to settle their respective obligations by delivery and purchase of an asset. It is executed off the floor of the exchange and reported to exchange officials who then cancel both positions.

Question #21 of 64

Question ID: 439014

The highest price a dealer is willing to pay to purchase a security is the:

✓ **A)** **bid price.**

✗ **B)** exercise price.

✗ **C)** offer price.

✗ **D)** strike price.

Explanation

The bid price is the highest price a dealer is willing to pay to purchase a security.

Question #22 of 64

Question ID: 439052

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

✓ **A)** **Closing a position through delivery refers exclusively to the physical delivery of goods.**

✗ **B)** As maturity of a contract approaches, more and more traders will attempt to close their positions.

✗ **C)** Except for *exchange for physicals (EFP)* transactions, futures contracts must be closed on the exchange floor.

✗ **D)** Few futures positions are settled by delivery of cash or assets.

Explanation

Delivery can also occur through cash settlement of gains and losses. The other statements are true. Approximately one percent of futures transactions are closed through actual delivery or cash settlement.

Question #23 of 64

Question ID: 439017

A call option gives the holder:

✗ **A)** **an obligation to buy at a certain price.**

✓ **B)** the right to buy at a specific price.

✗ **C)** an obligation to sell at a certain price.

✗ **D)** the right to sell at a specific price.

Explanation

A call gives the owner the right to call an asset away (buy it) from the seller.

Question #24 of 64

Question ID: 439032

Initial margin deposits for futures accounts are:

- ✗ **A) usually larger for the short position.**
- ✗ **B)** set by the Federal Reserve for U.S. markets.
- ✓ **C)** based on price volatility.
- ✗ **D)** typically 50% of the purchase price.

Explanation

Margin deposits for futures trades are based on the price volatility of the underlying asset, are set by the clearinghouse, are equal for long and short positions, and are typically a small percentage of the contract value.

Question #25 of 64

Question ID: 439042

Which of the following statements regarding a futures trade of a deliverable contract is **FALSE**?

- ✓ **A) Equilibrium futures price is known only at the end of the trading day.**
- ✗ **B)** The long is obligated to purchase the asset.
- ✗ **C)** The price is determined by open outcry.
- ✗ **D)** The short is obligated to deliver the asset.

Explanation

Each trade is made at the then current equilibrium price, determined by open outcry on the floor of the exchange, and is reported as it is executed. The long is obligated to buy, and the short is obligated to sell, the specified quantity of the underlying asset.

Question #26 of 64

Question ID: 439010

Russell Raven is a commodities trader. Raven is long wheat futures and has a short cash position in wheat. Which of the following best describes Raven's position?

- ✓ **A) Short the basis.**
- ✗ **B)** Long the basis.
- ✗ **C)** A selling hedge.
- ✗ **D)** A short hedge.

Explanation

Short the basis refers to a set of positions that consists of a long futures position and a short cash position. Positions that are short the basis benefit when the basis is weakening. This occurs when the futures price increases at a faster rate than the cash price or when the futures price decreases at a rate slower than the cash price. Note that a position that is short the basis is equivalent to a buying hedge.

Question #27 of 64

Question ID: 439055

Prior to contract expiration the short in a futures contract can avoid futures exposure by:

- ✗ **A)** **paying a cash settlement amount.**
- ✗ **B)** delivering the asset at the current spot price.
- ✗ **C)** using an exchange-for-physicals.
- ✓ **D)** entering into a reversing trade.

Explanation

Prior to expiration, a futures position (long or short) is closed out by an offsetting/reversing trade. The other methods are used to settle positions at contract expiration.

Question #28 of 64

Question ID: 439058

Most deliverable futures contracts are settled by:

- ✓ **A)** **an offsetting trade.**
- ✗ **B)** a cash payment at expiration.
- ✗ **C)** an exchange-for-physicals.
- ✗ **D)** delivery of the asset at contract expiration.

Explanation

Most futures positions are closed out by an offsetting trade at some point during life of the contract.

Question #29 of 64

Question ID: 439016

The formula for the payoff at expiration to a put option buyer is:

- ✗ **A)** **-max (0, X - S_T).**
- ✗ **B)** max (0, S_T - X).
- ✗ **C)** -max (0, S_T - X).
- ✓ **D)** max (0, X - S_T).

Explanation

The payoff to a put option buyer is max (0, X - S_T). Max (0, S_T - X) is the payoff to a call option buyer. -Max (0, S_T - X) and -max (0, X - S_T) are the payoffs to a call option seller and to a put option seller, respectively.

Question #30 of 64

Question ID: 439054

Which method is **NOT** an appropriate way to close out a futures contract?

- ✓ **A)** **Default.**
- ✗ **B)** Exchange for physicals.
- ✗ **C)** Delivery.
- ✗ **D)** Reverse trade.

Explanation

Default is failure to perform as required under the contract.

Question #31 of 64

Question ID: 439048

Richard Wilson is concerned about the credit risk on a particular over-the-counter (OTC) contract. How does the process of collateralization work in the OTC market?

- ✗ **A)** **There is no collateralization process in the OTC market.**
- ✗ **B)** Collateral is held by the exchange and losses are covered via the collateral at conclusion of the contract term.
- ✓ **C)** There is a mark to market feature and losses are settled in cash daily.
- ✗ **D)** Collateral is posted and losses are guaranteed by the exchange.

Explanation

The OTC market does not have a formal exchange. Credit risk is lessened through collateralization. Losses are settled in cash at the end of each day. The process is similar to trading on margin.

Question #32 of 64

Question ID: 439205

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

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

Explanation

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

Question #33 of 64

Question ID: 439015

Which of the following is *least likely* correct?

- ✗ **A)** **Speculators use derivatives due to the low initial investment required.**

✓ **B)** The initial investment in futures consists of the premium.

✗ **C)** Option contracts have an asymmetrical payoff.

✗ **D)** Futures contracts have a symmetrical payoff.

Explanation

The initial investment for futures consists of the initial margin requirement. Options are sold at the option premium.

Question #34 of 64

Question ID: 439019

An investor has been bullish on AAPL for quite some time, and has accumulated a large position totaling 1.2 million shares. The current stock price is $575 per share. If the investor is concerned about a decline in the price of the stock and elects to hedge the position by purchasing a 3-month put option, what is the profit on a per share basis if the stock price is $541 in 3 months, the strike price on the put is $575, and the put premium is $3.70?

✗ **A)** **-$34.00.**

✗ **B)** $30.30.

✗ **C)** $3.70.

✓ **D)** -$3.70.

Explanation

Profit = $S_T - S_0 + \max(0, X - S_T) - P_0$
= 541 - 575 + (575 - 541) - 3.70
= -3.70

The put transaction totally protects the investor from the stock price decline. The only cost is the put premium.

Question #35 of 64

Question ID: 439038

If the balance in a trader's account falls below the maintenance margin level, the trader will have to deposit additional funds into the account. The additional funds required is called the:

✓ **A)** **variation margin.**

✗ **B)** initial margin.

✗ **C)** margin call.

✗ **D)** marking to market.

Explanation

If the margin balance falls below a specified level (the maintenance margin), additional capital (the variation margin) must be deposited in the account. Initial margin is the capital that must be in the trader's account before the initiation of the margin trade. Marking to market is when any loss for the day is deducted from the trader's account, and any gains are added to the account.

Question #36 of 64

Question ID: 439018

What is the payoff and profit, respectively, to the call buyer on a stock, given the following specifics:

Call strike price: $62

Put strike price: $63

Stock price: $70

Call premium: $3.25

Put premium: $2.75

- ✗ **A) Payoff: $7.00; Profit: $2.75**
- ✗ **B)** Payoff: $0; Profit: $0
- ✗ **C)** Payoff: $8.00; Profit: $12.75
- ✓ **D)** Payoff: $8.00; Profit: $4.75

Explanation

Payoff: 70 - 62 = 8 maximum

Profit: Maximum payoff less the call premium of $3.25: 8 - 3.25 = 4.75

Question #37 of 64

Question ID: 439045

The clearinghouse in a futures contract performs all but which of the following roles? The clearinghouse:

- ✗ **A) guarantees traders against default from another party.**
- ✗ **B)** allows traders to reverse their position without having to contact the other side of the position.
- ✗ **C)** splits each trade and acts as a buyer to futures sellers and as a seller to futures buyers.
- ✓ **D)** guarantees the physical delivery of the underlying asset to the buyer of futures contracts.

Explanation

The clearinghouse does not guarantee the physical delivery of the underlying asset. Indeed, most futures contracts do not have a physical delivery, but are reversed.

Question #38 of 64

Question ID: 439026

Which of the following statements regarding the mark to market of a futures account is *least* accurate? Marking to market of a futures account:

- ✓ **A) is only done when the settlement price is below the maintenance price.**
- ✗ **B)** may be done more often than daily.
- ✗ **C)** may result in a margin balance above the initial margin amount.
- ✗ **D)** effectively adjusts the price of the future to the new equilibrium level.

Explanation

Futures accounts are marked to market daily based on the new settlement price, which can result in either an addition to or subtraction from the previous margin balance. Under extraordinary circumstances (volatility) the mark to market can be required more frequently. Once the margin is marked to market, the contract is effectively a futures contract at the new settlement price.

Question #39 of 64

Question ID: 439021

Arbitrageurs attempt to:

- ✗ **A) earn significant profits by making market bets regarding securities prices.**
- ✓ **B)** earn a riskless profit through the exploitation of security mispricings.
- ✗ **C)** earn a long-term profit by making consistent long term investments.
- ✗ **D)** neutralize a financial exposure as part of a risk management strategy.

Explanation

Arbitrageurs attempt to earn a riskless profit by exploiting the mispricing of securities.

Question #40 of 64

Question ID: 439009

Colin Cooper is in possession of a large quantity of wheat and expects prices to decline. Which of the following positions is most appropriate for Cooper?

- ✗ **A) Buying hedge.**
- ✗ **B)** Short the basis.
- ✗ **C)** Long hedge.
- ✓ **D)** Long the basis.

Explanation

A selling hedge, or being long the basis, is appropriate when a hedger possesses inventory of an asset and expects prices to decline. Long the basis refers to a set of positions that consists of a short futures position and a long cash position. Positions that are long the basis benefit when the basis is strengthening. This occurs when the cash price increases at a faster rate than the futures price or when the cash price decreases at a rate slower than the futures price.

Question #41 of 64

Question ID: 439031

An investor has a short position in T-bond futures, and due to a decrease in interest rates, is required to make an additional cash deposit to her futures account. This is an example of:

- ✗ **A) initial margin.**
- ✗ **B)** maintenance margin.
- ✗ **C)** minimum margin.
- ✓ **D)** variation margin.

Explanation

When the margin in a futures account falls below the maintenance margin, the additional margin required is called the variation margin.

Question #42 of 64

Question ID: 439047

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

- ✓ **A) has defaulted on one half of one percent of futures trades.**
- ✗ **B)** requires the daily settlement of all margin accounts.
- ✗ **C)** guarantees that traders in the futures market will honor their obligations.
- ✗ **D)** acts as the opposite side of all trades once they are initiated.

Explanation

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

Other information on the clearinghouse:

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

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

Question #43 of 64

Question ID: 439044

The settlement price for a futures contract is:

- ✓ **A) an average of the trade prices during the 'closing period'.**
- ✗ **B)** the price of the asset in the future for all trades made in the same day.
- ✗ **C)** the price at which all trades over a certain period are executed.
- ✗ **D)** the price of the last trade of a futures contract at the end of the trading day.

Explanation

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

Question #44 of 64

Question ID: 439040

The money added to a margin account to bring the account back up to the required level is known as the:

- ✗ **A) initial margin.**
- ✗ **B)** maintenance margin.
- ✗ **C)** daily settlement.
- ✓ **D)** variation margin.

Explanation

The money added to a margin account to bring the account back up to the required level is known as the variation margin. The first deposit is called the initial margin. The minimum allowed in the account is called the maintenance margin. The daily settlement process requires marking-to-market each day.

Question #45 of 64

Question ID: 439012

The practice of adjusting the margin balance in a futures account for the daily change in the futures price is called:

- ✗ **A) settling up.**
- ✗ **B)** the daily call.
- ✓ **C)** marking to market.
- ✗ **D)** a margin call.

Explanation

Marking to market is the practice of adding to or subtracting from the margin balance to adjust for the daily change in the contract value.

Question #46 of 64

Question ID: 439049

Jacob Donnie, FRM is studying futures settlement prices for a select group of stocks in the automotive industry. He has determined that over the past 5 months, there has been an inverted market in the automotive industry. What would that indicate for settlement prices during that time period?

- ✗ **A) Settlement prices have been parabolic.**
- ✗ **B)** Futures prices have been volatile.
- ✓ **C)** Settlement prices have been decreasing.
- ✗ **D)** Futures prices have been increasing.

Explanation

Decreasing settlement prices over time are most indicative of an inverted market.

Question #47 of 64

Question ID: 439034

Which of the following statements regarding margin in futures accounts is **FALSE**?

- ✓ **A) Margin is usually 10% of the contract value for futures contracts.**
- ✗ **B)** Margin *must* be deposited before a trade can be made.
- ✗ **C)** With futures margin, there is no loan of funds.
- ✗ **D)** Margin is resettled daily.

Explanation

The margin percentage is typically low as a percentage of the value of the underlying asset and varies among contracts on different assets based on their price volatility. The other statements are true.

Question #48 of 64

Question ID: 439022

Joe Mannes, FRM believes he has identified an arbitrage opportunity between the NASDAQ and the London Stock Exchange

(LSE). The stock he is looking at, Pharma PLC, is trading on NASDAQ for $76 and trading on the LSE for 52.03 GBP. The current exchange rate is 1.557$ / GBP. Is there a potential for an arbitrage profit, and if so, what would it be?

✓ **A) Yes; $5.00.**

✗ **B)** No.

✗ **C)** Yes; $4.75.

✗ **D)** Yes; $2.50.

Explanation

The U.S. dollar value of Pharma PLC on the LSE:

52.03 GBP x 1.557 $ / GBP = 81

Sell Pharma on LSE for $81 and buy Pharma on NASDAQ for $76. The arbitrage profit is $5.00 per share.

Question #49 of 64

Question ID: 439008

XYZ Corp. is a clearinghouse member for a futures exchange. Due to recent embezzlement, they have encountered some financial difficulty. Which of the following statements least likely describes a procedure that is used when a clearinghouse member is unable to meet its open contract obligations?

✗ **A) Surplus funds of the clearinghouse may be used at the discretion of the clearinghouse board.**

✓ **B)** Contributions to the guaranty fund by XYZ Corp may be used but not contributions made by other members.

✗ **C)** Contributions by other solvent clearinghouse members to the guaranty fund may also be used to cover deficits.

✗ **D)** A solvent clearinghouse member takes possession of all open fully margined customer positions.

Explanation

The following procedures are in place if a clearinghouse member is unable to meet its open contract obligations:

1. A solvent clearinghouse member takes possession of all open fully margined customer positions. All under-margined customer positions and the firm's proprietary positions are liquidated.

2. If the member's customer account with the clearinghouse is in deficit because of a liquidation, any additional margin the member had deposited at the clearinghouse is applied toward the deficit on the customer's positions.

3. If the defunct member's margin deposits on hand are not sufficient to cover the deficit, the member's exchange membership may be sold and the funds deposited in the guaranty fund by the member may be used.

4. If a deficit still exists, the surplus fund of the clearinghouse may be used at the discretion of the clearinghouse board.

5. Contributions by other solvent clearinghouse members to the guaranty fund may also be used. The guaranty fund may be replenished by a pro rata special assessment made by the remaining members of the clearinghouse.

Questions #50-51 of 64

It is April 15, and a trader is entered into a short position in two soybean meal futures contracts. The contracts expire on August 15, and call for the delivery of 100 tons of soybean meal each. Further, because this is a futures position, it requires the posting of a $3,000 initial margin and a $1,500 maintenance margin per contract. For simplicity, however, assume that the account is marked to market on a monthly basis. Assume the following represent the contract delivery prices (in dollars per ton) that prevail on each settlement date:

April 15 (initiation)	173.00
May 15	179.75
June 15	189.00
July 15	182.50
August 15 (delivery)	174.25

Question #50 of 64

Question ID: 439036

What is the equity value of the margin account on the May 15 settlement date, including any additional equity that is required to meet a margin call?

- ✗ **A) $1,350.**
- ✗ **B)** $$7,350.
- ✗ **C)** $2,300.
- ✓ **D)** $4,650.

Explanation

Use the following steps to calculate the margin account balance as of May 15.

At initiation: (Beginning Balance, April 15)

> Initial margin × number of contracts = 3,000 × 2 = 6,000
>
> Maintenance margin × number of contracts = 1,500 × 2 = 3,000

As of May 15: (Ending contract price per ton − beginning contract price per ton) × tons per contract × # contracts = (179.75 − 173.00) × 100 × 2 = 1,350

Since the trader is short, this amount is *subtracted* from the beginning margin balance, or 6,000 − 1,350 = 4,650.

Question #51 of 64

Question ID: 439037

Based on the May 15 settlement date, which of the following is *most* accurate?

- ✗ **A) Since the equity value of the margin account is below the maintenance margin, a variation margin is called to restore the equity value of the account to it's initial level.**
- ✓ **B)** No margin call or disbursement occurs.
- ✗ **C)** Since the equity value fell below the initial margin level, a variation margin of $650 is called.
- ✗ **D)** Since the equity value of the margin account is above the initial margin, the trader can withdraw $1,350.

Explanation

As of May 15, the margin balance is $4,650 (see solution to previous question). Since this is below the initial margin of $6,000 (both contracts), but still *above* the maintenance margin of $3,000, (for both contracts) no action is required.

There are three types of margin. The first deposit is called the *initial margin*. Initial margin must be posted before any trading takes place. Initial margin is fairly low and equals about one day's maximum price fluctuation. The margin requirement is low because at the end of every day there is a *daily settlement* process called marking-the-account-to-market. In *marking-to-market*, any losses for the day are removed from the trader's account and any gains are added to the trader's account. If the margin balance in the trader's account falls below a certain level (called the *maintenance margin*), the trader will get a margin call and have to deposit more money (called the *variation margin*) into the account to bring the account back up to the initial margin level.

Question #52 of 64

Question ID: 439006

Risk is necessary for the existence of an effective futures market. Which of the following statements least likely describes a requisite for a successful futures market?

- ✗ **A)** **An available underlying cash market is necessary.**
- ✗ **B)** No other liquid futures contracts can be available to hedge the same or similar risks.
- ✗ **C)** The grade of commodity must meet the quality standards called for in the contract.
- ✓ **D)** A futures market does not necessarily have to be based on supply and demand.

Explanation

In addition to the existence of risk, participants must be willing to use the futures markets to manage risk. For market participants, the following items are necessary:

• An available underlying cash market. Futures contracts must be based on real supply and demand economics. For example, economic activity such as the stock market, the stockyards, grain elevators, or the mortgage market must underlie an effective futures market.

• Transparency. Information regarding the underlying economic activity, the supply and demand, must also be widely available. If the underlying cash market is opaque, the corresponding futures market has less chance of success.

• Standardization. The grade or type of commodity must meet the quality standards called for in the contract.

• Efficient delivery infrastructure. Exchanges have made delivery easier with cash-settled contracts.

• No other liquid contracts. No other liquid futures contracts can be available to hedge the same or similar risks.

Question #53 of 64

Question ID: 439028

In commodity trading, the exchange removes any daily losses from a trader's account and adds any gains to the trader's account. This process is known as:

- ✗ **A)** **variation margin.**
- ✗ **B)** maintenance margin.
- ✗ **C)** initial margin.
- ✓ **D)** marking to market.

Explanation

To safeguard the clearinghouse, commodity exchanges require traders to settle their accounts on a daily basis. Marking to market is when any loss for the day is deducted from the trader's account, and any gains are added to the account.

Question #54 of 64

Question ID: 439211

In the commodity spot and futures markets, what effect on price fluctuations and market liquidity do speculators provide?

✓ **A) Smooth price fluctuations, provide market liquidity.**

✗ **B)** Lower margin rates, increase price volatility.

✗ **C)** Expand market breadth, reduce volatility, increase price volatility.

✗ **D)** Increase volume, volatility and liquidity risk, while providing market depth.

Explanation

Speculators smooth price fluctuations and add liquidity to the marketplace, but they can face funding liquidity if banks raise margin rates.

Question #55 of 64

Question ID: 439024

If an investor desires to take a short position in a particular type of commodity, but wishes to specify the quality of the underlying commodity, which is the appropriate type of contract she should use?

✗ **A) Neither a forward nor a futures contract allows such specificity.**

✓ **B)** Either a forward contract or a futures contract could be used.

✗ **C)** A forward contract would be preferred.

✗ **D)** A futures contract would be preferred.

Explanation

A forward contract is a private customized contract, so specifying quality is no problem. The futures exchange also allows specifying quality of a good that would be acceptable for settling the contract.

Question #56 of 64

Question ID: 439053

All of the following are methods to close out a futures position **EXCEPT**:

✓ **A) allowing the contract to expire without taking action.**

✗ **B)** delivery of the underlying commodity.

✗ **C)** through an exchange for physicals with another trader.

✗ **D)** engaging in an offsetting trade in the futures market.

Explanation

A futures contract cannot expire without any action being taken. If the contract has not been closed out through an offsetting trade, then one party must deliver the underlying commodity and the other party must purchase the commodity.

Question #57 of 64

Question ID: 439046

The clearinghouse, in U.S. futures markets, does **NOT**:

✗ **A) allow reversing trades.**

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

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

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

Explanation

The *exchange* decides which contracts will be traded and their specifications. The clearinghouse acts as the counterparty to every contract, guarantees performance, and allows traders to end their obligations through reversing (offsetting) trades.

Question #58 of 64

Question ID: 439051

Which of the following statements about closing a futures contract through offset is *most* accurate?

✗ **A) A low percentage of offsets take place *ex-pit*.**

✗ **B)** In an offset, or reversing trade, a trader makes an exact opposite trade (maturity, quantity, and good) to her current position, either through the clearinghouse or a private party.

✗ **C)** Offset is the least common method of closing a futures position.

✓ **D)** The clearinghouse nets the position to zero.

Explanation

An offset trade must be conducted on the floor of the exchange through the clearinghouse. Reverse, or offsetting, trades are the *most* common way to close a futures position. *Exchange for physicals (EFP)* involves private parties and takes place *ex pit*, or off the exchange floor.

Question #59 of 64

Question ID: 439039

When a futures trader receives a margin call what must he or she do to bring the position up to the initial margin? The futures trader must:

✓ **A) deposit variation margin.**

✗ **B)** deposit maintenance margin.

✗ **C)** deposit the daily settlement value.

✗ **D)** sell stock to cover the margin call.

Explanation

When a futures trader receives a margin call, he/she must deposit variation margin to bring the account up to the initial margin value.

Question #60 of 64

Question ID: 439202

Which of the following statements about arbitrage opportunities is **TRUE**?

✗ **A) There can never be an opportunity to make profits from arbitrage.**

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

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

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

Explanation

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

Question #61 of 64

Question ID: 439013

Comparing and contrasting the over-the-counter (OTC) market with the traditional exchange market, which is larger, and what would be a key advantage of OTC trading compared with traditional exchange trading?

✗ **A) OTC market is larger, and a key OTC advantage is that credit risk is eliminated or largely mitigated.**

✓ **B)** OTC market is larger, and a key OTC advantage is participants' flexibility to negotiate.

✗ **C)** OTC market is smaller, and a key OTC advantage is that terms are not set by any exchange.

✗ **D)** OTC market is smaller, and a key OTC advantage is calls are recorded, to prevent miscommunications.

Explanation

The OTC market is much larger than the exchange market, and offers advantages including no set terms, negotiating flexibility, and recorded calls.

Question #62 of 64

Question ID: 439020

Jim Bob and Joe Bob both are employed as portfolio managers at a regional investment firm based on Amarillo, Texas.

Jim Bob is examining employing a covered call strategy on a particular oil stock, and tells his colleague that he likes this approach, since it will increase expected returns on the portfolio while at the same time reducing downside risk.

Joe Bob is considering another approach. He is looking at an oil services firm and would like to employ a protective put strategy. He tells his colleague that this approach will permit his investors to have an unlimited profit potential while limiting potential losses to an amount equal to the initial stock price less the put premium.

Are Jim Bob and/or Joe Bob correct in their statements?

✗ **A) Jim Bob is correct; Joe Bob is incorrect.**

✗ **B)** Jim Bob is correct; Joe Bob is also correct.

✓ **C)** Jim Bob is incorrect; Joe Bob is also incorrect.

✗ **D)** Jim Bob is incorrect; Joe Bob is correct.

Explanation

A covered call strategy does indeed lower the risk by somewhat cushioning losses through receipt of the premium received on the short call option. However the upside is lost, since the strategy eliminates large upside gains. Expected return is thus reduced by this strategy.

The protective put strategy requires the actual purchase of a put option. The maximum loss is equal to the cost of the initial position, the stock price at the outset of the strategy plus the put premium, less the exercise price of the put option. Joe Bob incorrectly stated the maximum loss on the protective put strategy.

Question #63 of 64

Question ID: 439033

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

- ✗ **A)** **interest is charged on the margin loan balance.**
- ✗ **B)** the initial margin is effectively paid to the seller of the security by the buyer.
- ✓ **C)** additional payment is required if margin falls below the maintenance margin.
- ✗ **D)** the value of the security is the collateral for the loan.

Explanation

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

Question #64 of 64

Question ID: 439027

Which of the following statements *best* describes marking-to-market of a futures contract? At the:

- ✓ **A)** **end of the day, the gains or losses are tallied to the trader's account.**
- ✗ **B)** maturity of the futures contract, the gains or losses are tallied to the trader's account.
- ✗ **C)** end of the day, the maintenance margin is increased for traders who lost and decreased for traders who gained.
- ✗ **D)** conclusion of each trade, the gains or losses from all previous trades in the futures contract are tallied.

Explanation

Marking-to-market means that, at the end of the day, all gains or losses are tallied to the trader's account.