

**An Introduction to Derivatives and Risk Management 10th edition by Don M. Chance, Roberts Brooks  
Test Bank**

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**CHAPTER 2: STRUCTURE OF OPTIONS MARKETS**

**MULTIPLE CHOICE TEST QUESTIONS**

1. Identify the true statement regarding the largest derivatives exchanges.
  - a. CME Group is one of the top five largest derivatives exchange, based on volume
  - b. Intercontinental Exchange is one of the top five largest derivatives exchange, based on volume
  - c. The volume of trading exceeded one billion on each of the top five derivatives exchanges
  - d. Among the top 20 derivatives exchanges, several different continents are represented
  - e. all of the above
2. A call option priced at \$2 with a stock price of \$30 and an exercise price of \$35 allows the holder to buy the stock at
  - a. \$2
  - b. \$32
  - c. \$33
  - d. \$35
  - e. none of the above
3. A put option in which the stock price is \$60 and the exercise price is \$65 is said to be
  - a. in-the-money
  - b. out-of-the-money
  - c. at-the-money
  - d. exercisable
  - e. none of the above
4. Organized options markets are different from over-the-counter options markets for all of the following reasons except
  - a. exercise terms
  - b. physical trading floor
  - c. regulation
  - d. standardized contracts
  - e. credit risk
5. The number of options acquired when one contract is purchased on an exchange is
  - a. 1
  - b. 5
  - c. 100
  - d. 500
  - e. 8,000
6. The advantages of the over-the-counter options market include all of the following except
  - a. customized contracts
  - b. privately executed
  - c. freedom from government regulation
  - d. lower prices
  - e. none of the above

7. Which one of the following is not a type of transaction cost in options trading?
- the bid-ask spread
  - the commission
  - clearing fees
  - the cost of obtaining a quote
  - all of the above
8. If the market maker will buy at 4 and sell at 4.50, the bid-ask spread is
- 8.50
  - 4.25
  - 0.50
  - 4.00
  - none of the above
9. Which of the following is a legitimate type of option order on the exchange?
- purchase order
  - limit order
  - execution order
  - floor order
  - all of the above
10. The exercise price can be set at any desired level on each of the following types of options *except*
- FLEX options
  - equity options
  - over-the-counter options
  - all of the above
  - none of the above
11. An investor who owns a call option can close out the position by any of the following types of transactions *except*
- exercise
  - offset
  - expiring out-of-the-money
  - buying a put
  - none of the above
12. Which of the following is not the task of market makers?
- provide liquidity
  - offer to buy and sell
  - provide price transparency
  - d.** work as a sole specialist
  - none of the above
13. The option price is also referred to as the
- strike
  - spread
  - premium
  - fee
  - none of the above

14. Which of the following contract terms is not set by the futures exchange?
- the dates on which delivery can occur
  - the expiration months
  - the price
  - the deliverable commodities
  - the size of the contract
15. If an investor exercises a cash settled derivative,
- the transaction entails only a bookkeeping entry
  - must purchase the underlying instrument from the writer
  - immediately buy a put option to offset the call option
  - immediately write another call option to offset
  - none of the above
16. Which of the following organizations has the ultimate regulatory authority in the futures industry?
- National Futures Association
  - Commodity Futures Trading Commission
  - Commodity Exchange Authority
  - Securities and Exchange Commission
  - none of the above
17. The derivatives exchange with the largest trading volume is the
- Moscow Exchange
  - Nasdaq OMX
  - CME Group
  - Pacific Stock Exchange
  - National Stock Exchange of India
18. A writer selected to exercise an option is said to be
- marginal
  - assigned
  - restricted
  - designated
  - none of the above
19. All of the following are forms of options *except*
- convertible bonds
  - callable bonds
  - puttable bonds
  - mutual funds
  - none of the above
20. If the initial margin is \$5,000, the maintenance margin is \$3,500 and your balance is \$4,000, how much must you deposit?
- nothing
  - \$6,000
  - \$1,500
  - \$9,000
  - none of the above
21. In which city did organized option markets originate?

- a. New York
  - b. Chicago
  - c. Philadelphia
  - d. San Francisco
  - e. none of the above
22. If the initial margin is \$5,000, the maintenance margin is \$3,500 and your balance is \$3,100, how much must you deposit?
- a. \$1,500
  - b. \$400
  - c. 0
  - d. \$1,900
  - e. none of the above
22. An order that specifies a maximum price to pay if buying is a
- a. stop order
  - b. market order
  - c. limit order
  - d. all or none order
  - e. none of the above
23. What amount must a call writer pay if a cash-settled index call is exercised?
- a. difference between the index level and the exercise price
  - b. exercise price
  - c. difference between the exercise price and the index level
  - d. index level
  - e. none of the above
24. Option traders incur which of the following types of costs?
- a. margin requirements
  - b. taxes
  - c. stock trading commissions
  - d. a and b
  - e. a, b and c
25. The total number of long option contracts outstanding at any given time is called the
- a. market cap
  - b. sum options outstanding (SOO)
  - c. option wealth outstanding (OWO)
  - d. open interest
  - e. none of the above
26. The number of long or short futures positions outstanding is called the
- a. reportable position
  - b. open interest
  - c. minimum volume
  - d. spread position
  - e. none of the above
26. This individual maintains and attempts to fill public option orders but does not disclose them to others.
- a. liquidity provider

- b. board broker
  - c. order book official
  - d. registered option trader
  - e. none of the above
27. What intermediary guarantees an option writer's performance?
- a. credit worthiness rating company
  - b. brokerage
  - c. good-till-canceled order
  - d. clearinghouse
  - e. none of the above
28. Suppose you hold a call option. The stock price has recently been increasing-making your call option more valuable. Through what process might you take advantage of the liquid nature of the options market?
- a. offsetting order
  - b. contract reconciliation
  - c. mark to market order
  - d. settling up
  - e. none of the above
29. Where did the U.S. futures market originate?
- a. Kansas
  - b. New York
  - c. Minneapolis
  - d. Chicago
  - e. none of the above
30. Variation margin is which of the following?
- a. margin deposited as a result of marking-to-market
  - b. the difference in margin between hedger and speculator
  - c. margin differences according to trading style
  - d. margin set by the variability of a futures price
  - e. none of the above
31. Which of the following duties is not performed by the clearinghouse?
- a. holding margin deposits
  - b. guaranteeing performance of buyer and writer
  - c. maintaining records of transactions
  - d. lending money to meet margin requirements
  - e. none of the above
32. What are circuit breakers?
- a. rules that stop trading when futures are about to expire
  - b. a system that shuts down the exchange computer during periods of abnormal volume
  - c. limits on the number of contracts that can be traded on high volume days
  - d. rules that limit the number of contracts a speculator can hold
  - e. none of the above
33. A futures contract covers 5000 pounds with a minimum price change of \$0.01 is sold for \$31.60 per pound. If the initial margin is \$2,525 and the maintenance margin is \$1,000, at what price would there be a margin call?

- a. 31.91
  - b. 32.11
  - c. 31.29
  - d. 31.09
  - e. 31.80
34. One of the advantages of forward markets is
- a. performance is guaranteed by the G-30
  - b. trading is conducted in the evening over computers
  - c. the contracts are private and customized
  - d. trading is less costly and governed by more rules
  - e. none of the above
35. Individuals engaging in this type of trading strategy are characterized by their attempt to profit from guessing the direction of the market
- a. hedgers
  - b. spreaders
  - c. speculators
  - d. arbitraguers
  - e. none of the above
36. Despite the fact that forward contracts carry more credit risk than futures contracts, forward contracts offer what primary advantage over futures contracts?
- a. the over-the-counter forward market is a highly regulated market
  - b. forward contracts prevent the writer from assuming the credit risk of the buyer
  - c. terms and conditions are tailored to the specific needs of the two parties involved
  - d. transaction information between the two parties involved in the forward contract is readily available to the public
  - e. conditions of the forward contract, such as delivery date and location, cannot be altered
37. Which of the following correctly orders the process of daily settlement?
- a. clearinghouse officials establish a settlement price; each account is marked to market; accounts of those holding long/short positions are credited/debited appropriately; differences between today's settlement price and the previous days settlement price are determined
  - b. clearinghouse officials establish a settlement price; each account is marked to market; differences between today's settlement price and the previous day's settlement price are determined; accounts of those holding long/short positions are credited/debited appropriately
  - c. differences between today's settlement price and the previous day's settlement price are determined; accounts are marked to market; clearinghouse officials establish a settlement price; accounts of those holding long/short positions are credited/debited appropriately
  - d. clearinghouse officials establish a settlement price; differences between today's settlement price and the previous days settlement price are determined; accounts of those holding long/short positions are credited/debited appropriately; each account is marked to market
  - e. differences between today's settlement price and the previous day's settlement price are determined; accounts are marked to market; clearinghouse officials establish a settlement price; accounts of those holding long/short positions are credited/debited appropriately

## CHAPTER 2: STRUCTURE OF OPTIONS MARKETS

### TRUE/FALSE TEST QUESTIONS

- |   |   |     |   |
|---|---|-----|---|
| T | F | 1.  | The exercise price is also called the striking price.   |
| T | F | 2.  | The Put and Call Brokers and Dealers Association created the first organized options exchange.  |
| T | F | 3.  | An out-of-the-money call option has an exercise price less than the stock price.  |
| T | F | 4.  | A put option increases in value when the stock price decreases.   |
| T | F | 5.  | Futures contracts are similar to forward contracts because they both represent a  |
| T | F | 4.  | Credit risk is handled in forward markets by daily marking-to-market.   |
| T | F | 7.  | A limit move is when a futures price reaches its all time high or low price.  |
| T | F | 8.  | The over-the-counter options market is much larger than the exchange-listed options market.   |
| T | F | 9.  | When futures accounts are marked-to-market, an account balance below the maintenance margin must be brought up to the initial margin. |
| T | F | 10. | Position limits are restrictions on the number of transactions an investor can execute on a given day.                                |
| T | F | 11. | Exercise limits are restrictions on the number of options that can be exercised by an investor in a given day or series of days.      |
| T | F | 12. | A market maker is an options trader who buys and sells options off of the exchange floor.   |
| T | F | 13. | The bid price is the price paid to buy an option from a market maker.   |
| T | F | 14. | Options traders who hold their positions for very short periods of time are called position traders.                                  |
| T | F | 15. | An order placed by an investor for the broker to buy an option at the best available price is called a market order.                  |
| T | F | 16. | The number of option contracts outstanding at any given time is called the open interest.   |
| T | F | 17. | Most investors close their positions by exercising their options.   |
| T | F | 18. | Over-the-counter options are not subject to default.  |
| T | F | 19. | Indices measuring options market activity are simple to construct and widely quoted.  |
| T | F | 20. | The spread between the bid price and the ask price is a transaction cost to the option trader.  |

- T F 21. The options market is regulated by the Securities Investor Protection Corporation.
- T F 22. One party to a forward transaction does not bear the risk that the other party will default.
- T F 23. The Options Clearing Corporation guarantees the obligations of traders on many options exchanges.
- T F 24. Offsetting an over-the-counter option contract cancels both contracts.
- T F 25. A hedge fund is a very risky form of investment.
- T F 26. CBOE option market makers are also called liquidity providers.
- T F 27. Over-the-counter options dealers do not have to be members of an options exchange.
- T F 28. A market maker always avoids the cost of the bid-ask spread.
- T F 29. The majority of derivatives exchanges in the U.S. are fully automated.
- T F 30. Option commissions are set by the Chicago Board Options Exchange.
- T F 31. The daily settlement procedure is a major similarity between futures contracts and forward contracts.
- T F 32. Each futures contract has both a long and a short position and counts as only one unit of open interest.
- T F 33. An investor who is long an over-the-counter call option is exposed to the risk that the call writer will default on her obligations should the call option end up in-the-money.
- T F 34. Exercising a stock put option means the put seller must sell stock at the stated strike price.
- T F 35. The largest futures exchange in the United States is the EMC Group.