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?
   a. the bid-ask spread
   b. the commission
   c. clearing fees
   d. the cost of obtaining a quote
   e. all of the above

8. If the market maker will buy at 4 and sell at 4.50, the bid-ask spread is
   a. 8.50
   b. 4.25
   c. 0.50
   d. 4.00
   e. none of the above

9. Which of the following is a legitimate type of option order on the exchange?
   a. purchase order
   b. limit order
   c. execution order
   d. floor order
   e. all of the above

10. The exercise price can be set at any desired level on each of the following types of options *except*
   a. FLEX options
   b. equity options
   c. over-the-counter options
   d. all of the above
   e. 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*
   a. exercise
   b. offset
   c. expiring out-of-the-money
   d. buying a put
   e. none of the above

12. Which of the following is not the task of market makers?
   a. provide liquidity
   b. offer to buy and sell
   c. provide price transparency
   d. work as a sole specialist
   e. none of the above

13. The option price is also referred to as the
   a. strike
   b. spread
   c. premium
   d. fee
   e. none of the above

14. Which of the following contract terms is not set by the futures exchange?
    a. the dates on which delivery can occur
    b. the expiration months
    c. the price
    d. the deliverable commodities
    e. the size of the contract

15. If an investor exercises a cash settled derivative,
    a. the transaction entails only a bookkeeping entry
    b. must purchase the underlying instrument from the writer
    c. immediately buy a put option to offset the call option
    d. immediately write another call option to offset
    e. none of the above

16. Which of the following organizations has the ultimate regulatory authority in the futures industry?
    a. National Futures Association
    b. Commodity Futures Trading Commission
    c. Commodity Exchange Authority
    d. Securities and Exchange Commission
    e. none of the above

17. The derivatives exchange with the largest trading volume is the
    a. Moscow Exchange
    b. Nasdaq OMX
    c. CME Group
    d. Pacific Stock Exchange
    e. National Stock Exchange of India

18. A writer selected to exercise an option is said to be
    a. marginal
    b. assigned
    c. restricted
    d. designated
    e. none of the above

19. All of the following are forms of options *except*
    a. convertible bonds
    b. callable bonds
    c. puttable bonds
    d. mutual funds
    e. 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?
    a. nothing
    b. $6,000
    c. $1,500
    d. $9,000
    e. 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

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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.