

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?

- 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
- performance is guaranteed by the G-30
 - trading is conducted in the evening over computers
 - the contracts are private and customized
 - trading is less costly and governed by more rules
 - 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
- hedgers
 - spreaders
 - speculators
 - arbitraguers
 - 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?
- the over-the-counter forward market is a highly regulated market
 - forward contracts prevent the writer from assuming the credit risk of the buyer
 - terms and conditions are tailored to the specific needs of the two parties involved
 - transaction information between the two parties involved in the forward contract is readily available to the public
 - 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?
- 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
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TRUE/FALSE TEST QUESTIONS

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| 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. |

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| 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. |