Chapter 2—The Creation of Financial Assets

TRUE/FALSE

1. The primary role of organized security exchanges is to raise capital (money) for firms.

   ANS: F PTS: 1
   NAT: AACSB: Reflective thinking | understanding investments

2. A direct transfer of funds from savers to firms occurs when new securities are issued in the primary market.

   ANS: T PTS: 1
   NAT: AACSB: Analytic skills | understanding investments

3. A commercial bank is an example of a financial intermediary.

   ANS: T PTS: 1
   NAT: AACSB: Reflective thinking | knowledge of financial markets and interest rates

4. The direct sale of new securities to a pension plan is a private placement, and the securities do not have to be registered with the SEC.

   ANS: T PTS: 1
   NAT: AACSB: Reflective thinking | understanding investments

5. In an "underwriting" the investment banker guarantees the firm selling the securities a specified amount.

   ANS: T PTS: 1
   NAT: AACSB: Reflective thinking | understanding investments

6. In a "best effort" sale of securities, the risk of the sale rests with the investment banker.

   ANS: F PTS: 1
   NAT: AACSB: Reflective thinking | understanding investments

7. The "syndicate's" role in an underwriting is to sell the new issue of securities.

   ANS: T PTS: 1
   NAT: AACSB: Reflective thinking | understanding investments

8. If the underwriter overprices a new issue, the market price of the securities will rise.

   ANS: F PTS: 1
   NAT: AACSB: Analytic skills | understanding investments

9. A prospectus is required when a corporation issues new securities that are sold to the general public.

   ANS: T PTS: 1
   NAT: AACSB: Reflective thinking | understanding investments

10. The preliminary prospectus ("red herring") does not include the offer price of a new stock issue.

ANS: T PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

11. The cost of an underwriting (to the firm issuing the securities) is the difference between the price of the public and the proceeds received by the firm.

ANS: T PTS: 1
NAT: AACSB: Analytic skills | understanding investments

12. A new issue of corporate securities sold to the general public must be registered with the SEC.

ANS: T PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

13. The SEC establishes the price of a new stock issue.

ANS: F PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

14. If the price of an initial public offering of stock rises, the windfall gain goes to the underwriter.

ANS: F PTS: 1
NAT: AACSB: Analytic skills | understanding investments

15. A "lock-up" refers to a security transaction with an assured profit.

ANS: F PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

16. A shelf-registration involves the selling of new securities without having them registered with the SEC.

ANS: F PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

17. Financial intermediaries facilitate the flow of funds from firms to savers.

ANS: F PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

18. Commercial banks offer money market accounts to compete with money market mutual funds.

ANS: T PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

19. There is no secondary market for negotiable CDs (i.e., jumbo certificates of deposit).

ANS: F PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

20. Bank deposits are safe since they are insured by the Securities and Exchange Commission (SEC).

ANS: F PTS: 1
NAT: AACSB: Reflective thinking | knowledge of financial markets and interest rates

21. Money market mutual funds acquire short-term money market instruments such as commercial paper.

ANS: T PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

22. Commercial paper is a secured, short-term note.

ANS: F PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

23. When a seller executes a repurchase agreement, the seller agrees to repurchase the asset at a lower price.

ANS: F PTS: 1
NAT: AACSB: Analytic skills | understanding investments

24. One of the major advantages associated with liquid money market securities is safety of principal.

ANS: T PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

25. The shares of money market mutual funds are insured by the federal government up to $100,000.

ANS: F PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

26. Treasury bills have no risk of default but risk of loss of interest payments.

ANS: F PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

27. A Eurodollar CD is a certificate of deposit issued in the United States by a foreign bank.

ANS: F PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

28. Funds invested in a money market mutual fund are insured by FDIC.

ANS: F PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

MULTIPLE CHOICE

1. Which of the following is not a financial intermediary?
   a. commercial bank
   b. stock exchange
   c. savings and loan association
   d. credit union

ANS: B PTS: 1
NAT: AACSB: Reflective thinking | knowledge of financial markets and interest rates

2. Commercial banks issue
   1. demand deposits (checking accounts)
   2. negotiable certificates of deposit
   3. money market accounts

   a. 1 and 2
   b. 1 and 3
   c. 2 and 3
   d. all of these choices

   ANS: D PTS: 1
   NAT: AACSB: Reflective thinking | knowledge of financial markets and interest rates

3. Financial intermediaries
   1. transfer funds from borrowers to savers
   2. create claims on themselves
   3. transfer funds from savers to borrowers
   4. create claims on lenders

   a. 1 and 2
   b. 1 and 4
   c. 2 and 3
   d. only 3

   ANS: C PTS: 1
   NAT: AACSB: Reflective thinking | knowledge of financial markets and interest rates

4. An investment banker
   a. issues checking and savings accounts
   b. facilitates the sale of new securities
   c. is another name for a brokerage firm
   d. makes loans to new firms

   ANS: B PTS: 1
   NAT: AACSB: Reflective thinking | understanding investments

5. Which of the following is not part of the underwriting process?
   a. the prospectus
   b. the originating house
   c. the SIPC
   d. the SEC

   ANS: C PTS: 1
   NAT: AACSB: Reflective thinking | understanding investments

6. The syndicate
   1. facilitates the sale of new securities
   2. is formed by the originating house
   3. creates a secondary market in stocks

   a. 1 and 2
   b. 1 and 3

c. 2 and 3
d. all of these choices

ANS: A PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

7. If the initial offer price of a new issue is too low,
   1. demand will exceed supply
   2. supply will exceed demand
   3. the price of the securities will rise
   4. the price of the securities will fall

   a. 1 and 3
   b. 1 and 4
   c. 2 and 3
   d. 2 and 4

   ANS: A PTS: 1
   NAT: AACSB: Analytic skills | understanding investments

8. The final prospectus does not include
   a. the firm's balance sheet
   b. the price of the securities sold to the public
   c. the underwriter's profit on the sale
   d. the underwriting discount

   ANS: C PTS: 1
   NAT: AACSB: Analytic skills | understanding investments

9. A new issue of corporate securities sold to the general public must be
   a. registered with the SEC
   b. initially sold through brokers
   c. offered initially to existing stockholders
   d. bought by specialists in corporate securities

   ANS: A PTS: 1
   NAT: AACSB: Reflective thinking | understanding investments

10. Which of the following is not a short-term, liquid asset?
    a. negotiable certificate of deposit
    b. U.S. Treasury bills
    c. corporate stock
    d. commercial paper

    ANS: C PTS: 1
    NAT: AACSB: Reflective thinking | understanding investments

11. Money market mutual funds invest in
    1. commercial paper
    2. repurchase agreements
    3. corporate bonds

    a. 1 and 2
    b. 1 and 3
    c. 2 and 3

d. all of these choices

ANS: A PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

12. The deregulation of the banking system has
    a. increased the growth of money market mutual funds
    b. resulted in lower interest rates
    c. blurred distinctions among financial intermediaries
    d. reduced the power of the SEC

ANS: C PTS: 1
NAT: AACSB: Reflective thinking | knowledge of financial markets and interest rates

13. Commercial paper is
    a. a short-term unsecured debt of a corporation
    b. a short-term secured debt of a corporation
    c. a long-term unsecured debt of a corporation
    d. a long-term secured debt of a corporation

ANS: A PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

14. FDIC insures
    a. treasury bills
    b. money market mutual funds
    c. savings accounts
    d. repurchase agreements

ANS: C PTS: 1
NAT: AACSB: Reflective thinking | understanding investments

15. Which of the following does not have default risk?
    a. money market mutual funds
    b. commercial paper
    c. negotiable certificates of deposit
    d. treasury bills

ANS: D PTS: 1
NAT: AACSB: Reflective thinking | understanding risk and return