CHAPTER 33
MARKET ORGANIZATION AND STRUCTURE

1. (C) 83% $15.43

Explanation

To obtain the result:

Part 1: Calculate Margin Return:

Margin Return % = [((Ending Value - Loan Payoff) / Beginning Equity Position) - 1] * 100 =

= [(([$24 x 1,000] - [$18 x 1,000 x 0.60]) / ($18 x 0.40 x 1,000)) - 1] x 100 =

= 83.33%

Alternative (Check):

Calculate the all cash return and multiply by the margin leverage factor.

= [(24,000 - 18,000)/18,000] x [1 / 0.40] = 33.33% x 2.5 = 83.33%

Part 2: Calculate Margin Call Price:

Since the investor is long (purchased the stock), the formula for the margin call price is:

Margin Call = (original price) x (1 - initial margin) / (1 - maintenance margin)

= $18 x (1 - 0.40) / (1 - 0.30) = **$15.43**

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

(Study Session 11, Module 33.1, LOS 33.a)

SchweserNotes - Book 3

2. (B) $3,000.

Explanation

An initial margin requirement of 40% would mean that the investor must put up 40% of the funds and brokerage firm may lend the 60% balance. Therefore, for this example (100 shares) * ($50) = $5,000 total cost. $5,000 * 0.60 = $3,000.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

3. (A) **brokered market.**

Explanation

Brokered markets are typically the best market structure for unique items. A broker adds value by locating a counterparty to take the opposite side of a trade of such an item.(Study Session 11, Module 33.3, LOS 33.j)

Related Material

SchweserNotes - Book 3

4. (B) **the limit is between the best bid and the best ask.**

Explanation

A limit order with a limit price between the best bid and the best ask is said to be "inside the market" or "making a new market." A limit order that has not yet been executed is a "standing limit order."

(Study Session 11, Module 33.3, LOS 33.h)

Related Material

SchweserNotes - Book 3

5. (C) **securitizers.**

Explanation

Securitizers are financial intermediaries that assemble large pools of similar financial assets, such as mortgages or loans, and issue securities that represent interests in the pool. Block brokers assist their clients with large trades of securities. Arbitrageurs simultaneously buy and sell the same asset in different markets to take advantage of different prices for the same asset.

(Study Session 11, Module 33.1, LOS 33.d)

Related Material

SchweserNotes - Book 3

6. (B) **standardized terms.**

Explanation

Futures are forward contracts that trade on exchanges and have standardized terms, in contrast with forward contracts, which are customized instruments. A futures clearinghouse reduces counterparty risk by guaranteeing the performance of buyers and sellers. Futures contracts trade on organized exchanges and are more liquid than forward contracts.

(Study Session 11, Module 33.1, LOS 33.c)

Related Material

SchweserNotes - Book 3

7. (B) determining equilibrium interest rates and allocating capital to its most productive uses.

Explanation

The main functions of the financial system are to allow individuals and organizations to save, borrow, raise capital, and manage risks; to determine equilibrium rates of return that equate the amounts of lending and borrowing; and to allocate capital to its most productive uses. The money supply is typically controlled by countries' central banks.

(Study Session 11, Module 33.1, LOS 33.a)

Related Material

SchweserNotes - Book 3

8. (B) an order-driven market.

Explanation

A crossing network is an example of an order-driven market. Orders are batched together and crossed (matched) at specific times during the trading day at prices based on those of another exchange. Price-driven markets and quote-driven markets are other terms for dealer or over-the-counter markets.

For Further Reference:

(Study Session 11, Module 33.3, LOS 33.j)

CFA® Program Curriculum, Volume 4, page 171

Related Material

SchweserNotes - Book 3

9. (B) 50%.

Explanation

Profit = 10,000 - 8,000 = 2,000

Return = 2,000 / 4,000 = 50%

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

10. (C) money markets.

Explanation

"Money markets" generally refers to markets for debt securities maturing in one year or less. Forward markets refer to contracts for the future exchange of an asset at a price established today. Primary markets are the markets for newly issued securities.

(Study Session 11, Module 33.1, LOS 33.b)

Related Material

SchweserNotes - Book 3

11. (C) placed to protect the gains on a long position.

Explanation

Stop loss sell orders are limit sell orders that are placed below market price. When the share price drops to the designated price, a sell order is executed protecting the investor from further declines.

(Study Session 11, Module 33.3, LOS 33.g)

Related Material

SchweserNotes - Book 3

12. (A) $16.67.

Explanation

Margin call trigger price = $25 x [(1 - 0.5)] / (1 - 0.25)] = $16.67.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

13. (A) The short seller is required to replace the borrowed securities within six months of a short sale.

Explanation

There is no maximum time for which a security can be borrowed. It must be returned whenever the lender requires it to be.

For Further Reference:

(Study Session 11, Module 33.2, LOS 33.e)

CFA® Program Curriculum, Volume 4, page 155

Related Material

SchweserNotes - Book 3

14.

(C)	Minimum amount of equity required of the investor	A deposit must be made to bring the margin back to the maintenance margin

Explanation

The initial margin requirement refers to the minimum amount of equity required of the investor.

With equities, if the margin falls below the maintenance margin, funds must be deposited to bring it back up to the maintenance margin level.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

15. (B) No, he meets the minimum maintenance margin requirement.

Explanation

Total original value by held Jensen is 400 × $60 =$24,000.

Amount of equity is 50% ($24,000) = $12,000.

Current total value is 400 × $40 = $16,000

So Jensen's equity is $16,000 - $12,000 = $4,000 which is 4,000/16,000 = 25% of the total market value.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

16. (A) An apartment complex.

Explanation

Real assets are assets with a physical presence such as real estate or equipment and machinery. An investment in an apartment complex is a real estate investment and therefore would be considered a real asset.

(Study Session 11, Module 33.1, LOS 33.b)

Related Material

SchweserNotes - Book 3

17. (C) 40%.

Explanation

200 shares x $35 = $7000 Initial Market Value

$7000 x .50 = $3500 cash payment and $3500 borrowed.

The new market value of the stock after price increase is (200 x $42) = $8400. If Ritchie sold his holdings he would have $4900 ($8400 - $3500) left after the loan was paid. So Ritchie's return on his original $3500 investment is:

$4900/3500 - 1 = 1.4 - 1.0 = 0.40 = 40%.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

18. (B) Prevailing market prices are determined by primary market transactions and are used in pricing new issues.

Explanation

Prevailing market prices are determined by the transactions that take place on the secondary market. This information is used to determine the price of new issues sold on primary markets.

(Study Session 11, Module 33.3, LOS 33.i)

Related Material

SchweserNotes - Book 3

19. (B) $24,000.

Explanation

The margin requirement represents the amount of money an investor must put down on the purchase. So Kirk must put $24,000 down ($60,000 x .40 = $24,000) and can borrow the balance.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

20. (B) minimum amount of funds that must be supplied when purchasing a security on margin.

Explanation

Margin is the amount of equity in the account at a given time. Initial margin is the amount of equity required initially to execute an order.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

21. (B) placing a stop buy order.

Explanation

A stop buy order above the current market price would execute if the market price increased to the specified stop price. This would limit the short seller's losses if the stock price increased.

Buying a put option would increase the investor's short exposure to the stock price. Setting a limit price on the order to sell short would affect the price at which the short sale could execute, but it would not limit the short seller's potential losses.

(Study Session 11, Module 33.2, LOS 33.e)

Related Material

SchweserNotes - Book 3

22. (B) Currency swaps.

Explanation

Contracts include forwards, futures, options, swaps, and insurance contracts. Commercial paper is a debt security. Depository receipts are shares in a pooled investment vehicle, such as a mutual fund or an exchange-traded fund.

(Study Session 11, Module 33.1, LOS 33.c)

Related Material

SchweserNotes - Book 3

23. (A) Call markets are markets in which the stock is only traded at specific times.

Explanation

Continuous markets are markets where trades occur at any time the market is open (i.e., they do not need to be open 24 hours per day). Setting one negotiated price is a method used in major continuous markets to set the opening price.

(Study Session 11, Module 33.3, LOS 33.j)

Related Material

SchweserNotes - Book 3

24. (B) market order.

Explanation

A market order is an order to buy or sell a security immediately at the best available price. A limit order is an order to buy at the specified limit price or lower, or to sell at the limit price or higher. A stop order is an order to buy if the market price increases to the specified stop price, or to sell if the market price decreases to the stop price.

(Study Session 11, Module 33.3, LOS 33.h)

Related Material

SchweserNotes - Book 3

25. (C) operational efficiency.

Explanation

Operational efficiency refers to low transactions costs. A financial system exhibits informational efficiency if prices quickly reflect all information relevant to fundamental value. A market exhibits allocational efficiency if it results in capital being directed to its most productive uses.

(Study Session 11, Module 33.3, LOS 33.k)

Related Material

SchweserNotes - Book 3

26. (B) validity and execution instructions.

Explanation

Good-till-cancelled is a validity instruction, which indicates when an order may be filled. Execution instructions include limit orders and market orders, as well as instructions regarding trade size and visibility. A clearing instruction indicates how to arrange final settlement of the trade.

For Further Reference:

(Study Session 11, Module 33.3, LOS 33.g)

CFA® Program Curriculum, Volume 4, page 211

Related Material

SchweserNotes - Book 3

27. (C) -30%.

Explanation

With a leverage ratio of 3 and a 10% decrease in share value, the investor's return is 3 x -10% = -30%.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

28. (A) $80.

Explanation

The initial margin requirement is $8,000 / (200 x $100) = 0.40. In a long stock position, the equation to determine the margin call price is:

long = [(original price)(1 - initial margin %)] / [1 - maintenance margin %]

= $100(1 - 0.4) / (1 - 0.25) = $80

Alternatively, the margin loan is (200 x $100) - $8,000 = $12,000. The minimum value of the long position that meets the maintenance margin requirement is $12,000 / (1 - 0.25) = $16,000. The share price at which the long position has this value is $16,000 / 200 = $80.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

29. (C) validity and execution instructions.

Explanation

Fill or kill is a validity instruction as it indicates when the order can be filled (i.e. immediately or cancel the order). A limit buy order is an execution instruction as it indicates how the order should be filled (e.g. buy at $92 or less). Clearing instructions indicate how to settle the trade (i.e., how and when to transfer the cash and the security).

(Study Session 11, Module 33.3, LOS 33.g)

Related Material

SchweserNotes - Book 3

30. (A) does not receive the dividends.

Explanation

The short seller pays all dividends to the lender, loses if stock prices *rise,* and is required to post a margin account. A short seller often places a *stop buy* order to protect the short sale position from a rising market.

(Study Session 11, Module 33.2, LOS 33.e)

Related Material

SchweserNotes - Book 3

31. (A) **Behind-the-market limit buy order.**

Explanation

"Behind the market" refers to a buy order with a limit price less than the best bid, or a sell order with a limit price higher than the best ask. A limit order that is behind the market (i.e., an order to buy for less than the market price or sell for more than the market price) will not be filled unless the market price moves to the order's limit price. "Inside the market" refers to orders with limit prices between the best bid and best ask. "Aggressively priced" refers to a buy order with limit prices higher than the best ask or a sell order with a limit price lower than the best bid. Aggressively priced limit orders are most likely to be filled immediately.

For Further Reference:

(Study Session 11, Module 33.3, LOS 33.h)

CFA® Program Curriculum, Volume 4, page 161

Related Material

SchweserNotes - Book 3

32. (B) **73.8%.**

Explanation

Margin debt = 40% x $50 = $20; Interest = $20 x 0.05 = $1.

Equity % = [Value - (margin debt + interest)] / Value

$80 - $21 / $80 = 73.8%

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

33. (B) **250%.**

Explanation

One quick (and less than intensive) way to calculate the answer to this on the examination (and it is very important to save time on the examination) is to first calculate the return if all cash, then calculate the margin leverage factor and then finally, multiply the leverage factor times the all cash return to obtain the margin return.

Calculations:

Step 1: Calculate All Cash Return:

Cash Return % = [(Ending Value / Beginning Equity Position) - 1] x 100

= [(($200 x 200) / ($100 x 200)) - 1] x 100 = **100%**

Step 2: Calculate Leverage Factor:

Leverage Factor = 1 / Initial Margin % = 1 / 0.40 = **2.50**

Step 3: Calculate Margin Return:

Margin Transaction Return = All cash return x Leverage Factor = 100% x 2.50 = **250%**

Note: You can verify the margin return as follows:

Margin Return % = [((Ending Value - Loan Payoff) / Beginning Equity Position) - 1] x 100

= [(([$200 x 200] - [$100 x 200 x 0.60]) / ($100 x 0.40 x 200)) - 1] x 100

= [((40,000 - 12,000) / 8,000) - 1] x 100 = **250%**

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

34. (A) **The short seller may withdraw the proceeds of the short sale.**

Explanation

Proceeds from the short sale must remain in the brokerage account along with the required margin deposit.

(Study Session 11, Module 33.2, LOS 33.e)

Related Material

SchweserNotes - Book 3

35. (A) **100%.**

Explanation

$75/share x 100 shares = $7,500.

50% margin means investor only pays half of the $7,500 in cash, or $3,750, and borrows the remaining $3,750.

Rate of return = (market value - initial investment - margin loan repayment) / initial equity

= ($11,250 - $3,750 - $3,750) / $3,750 = 100%.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

36. (A) **common stock and warrants.**

Explanation

Common stock, preferred stock, and warrants are equity securities. Certificates of deposit are debt securities. Exchange-traded funds are pooled investment vehicles.

(Study Session 11, Module 33.1, LOS 33.c)

Related Material

SchweserNotes - Book 3

37. (C) 15.6% $25.60

Explanation

Part 1: Calculate Margin Return:

Margin Return %

= [((Ending Value - Loan Payoff) / Beginning Equity Position) - 1] x 100

= [(([$34 x 1,000] - [$32 x 1,000 x 0.60]) / ($32 x 0.40 x 1,000)) - 1] x 100

= 15.6%

Alternative (Check): Calculate the all cash return and multiply by the margin leverage factor.

[(34,000 - 32,000) / 32,000] x [1 / 0.40] = 6.35% x 2.5 = **15.6%**

Part 2: Calculate Margin Call Price:

The formula for the margin call price is:

Margin Call = (original price) x (1 - initial margin) / (1 - maintenance margin)

= $32 x (1 - 0.40) / (1 - 0.25) = approximately **$25.60**

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

38. (C) preventing investors from generating abnormal profits by trading on information.

Explanation

One of the purposes of the financial system is to allow investors to trade on (public) information. Other purposes of the financial system include allocating financial capital to its most productive uses, and bringing together those who wish to save with those who wish to borrow.

(Study Session 11, Module 33.1, LOS 33.a)

Related Material

SchweserNotes - Book 3

39. (B) stop loss buy.

Explanation

A short position profits from declines in stock price and experiences losses as the price rises. A stop loss buy is a limit order that is placed above the market price. When the stock price reaches the stop price, the limit order is executed curtailing further loses.

(Study Session 11, Module 33.3, LOS 33.g)

Related Material

SchweserNotes - Book 3

40. (B) regulators with information about market participants.

Explanation

Secondary markets are important because they provide liquidity and continuous information to investors. The liquidity of the secondary markets adds value to both the investor and firm because more investors are willing to buy issues in the primary market, when they know these issues will later become liquid in the secondary market. Therefore, the secondary market makes it easier for firms to raise external capital.

(Study Session 11, Module 33.3, LOS 33.i)

Related Material

SchweserNotes - Book 3

41. (C) Return on investment is 50%.

Explanation

Return on invested equity is ($45 - $40) / $10 = 50%.

The leverage ratio is purchase price / equity = $40 / $10 = 4.

Margin call price is $40 x [(1 - 0.25) / (1 - 0.20)] = $37.50.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

42. (C) 40%.

Explanation

(50 - 40) / (40 x 0.6) = 41.67%.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

43. (A) capital market.

Explanation

The exchange can be described as part of the secondary capital markets. A security is first issued in the primary market, and then it trades among investors in the secondary market. The money market refers to the market for short-term debt instruments (usually with maturities of less than one year) such as T-bills.

(Study Session 11, Module 33.1, LOS 33.b)

Related Material

SchweserNotes - Book 3

44. (B) -35%.

Explanation

Hampton originally purchased 100 shares at $75 for a total value of $7500. Half of the value ($3750) was borrowed and Hampton paid cash for the other half. The current total market value of the stock is $6200. If Hampton sells her holdings she will have $2450 left after she pays off the loan. Hampton's return on her original investment is:

$2450/3750 - 1 = 0.65 - 1 = -0.35 = -35%.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

45. (C) The short seller must pay all dividends due to the lender of the shorted stock.

Explanation

The short seller must pay any dividends on the stock to the owner of the borrowed shares. The short seller must also deposit margin money to guarantee the eventual repurchase of the security.

(Study Session 11, Module 33.2, LOS 33.e)

Related Material

SchweserNotes - Book 3

46. (B) durable equipment.

Explanation

Real assets include real estate, durable equipment, and other physical assets. Equity securities such as industrial stocks are classified as financial assets. Currencies are a separate classification of investment assets.

(Study Session 11, Module 33.1, LOS 33.b)

Related Material

SchweserNotes - Book 3

47. (A) financial assets.

Explanation

Financial assets, such as shares of stock in a company, are claims against physical or real assets.

(Study Session 11, Module 33.1, LOS 33.c)

Related Material

SchweserNotes - Book 3

48. (B) the sale of new securities to investors.

Explanation

A primary market is a market for new issues of securities.

(Study Session 11, Module 33.3, LOS 33.i)

Related Material

SchweserNotes - Book 3

49. (B) Margin accounts can be used to purchase securities by borrowing part of the purchase price.

Explanation

Margin accounts are brokerage accounts that allow investors to borrow part of the purchase price from the broker.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

50. (B) Investors are well informed about the risk and return of various investments.

Explanation

Capital will flow to its most valuable uses if markets function well and investors are well informed about the risk and return characteristics of various investments. Allocation of capital to its most valuable uses does not require that all investors have complete information or that financial markets are frictionless.

(Study Session 11, Module 33.1, LOS 33.a)

Related Material

SchweserNotes - Book 3

51. (C) reduce information gathering costs by requiring common financial reporting standards.

Explanation

One of the objectives of market regulation is to require firms to report their financial performance according to a single set of standards, such as those of the IASB or FASB, thereby reducing market participants' cost of gathering information. Market regulation is not designed to prevent uninformed investors from trading, but to protect unsophisticated investors and thereby preserve trust in the financial markets. An objective of market regulation is to prevent those with non-public information from profiting at the expense of other investors, but not necessarily to make all inside information public.

(Study Session 11, Module 33.3, LOS 33.l)

Related Material

SchweserNotes - Book 3

52. (A) allocationally efficient.

Explanation

Markets are said to be allocationally efficient when capital is directed to its most productive uses. Operationally efficient markets are those that have low trading costs. Informationally efficient markets are those in which security prices reflect all information associated with fundamental value in a timely fashion.

(Study Session 11, Module 33.3, LOS 33.k)

Related Material

SchweserNotes - Book 3

53. (C) The Federal Reserve sets the maximum maintenance margin.

Explanation

The Federal Reserve sets the minimum maintenance margin and individual investment companies may set higher margins if they wish.

(Study Session 11, Module 33.2, LOS 33.f)

Related Material

SchweserNotes - Book 3

54. (B) low transaction costs.

Explanation

An operationally efficient market is a market in which the cost of each transaction is minimal. Informational efficiency means prices in the market reflect all information currently available to participants. Price continuity means that prices do not adjust much from one transaction to the next unless new information about firm value becomes available.

For Further Reference:

(Study Session 11, Module 33.3, LOS 33.k)

CFA® Program Curriculum, Volume 4, page 175

Related Material

SchweserNotes - Book 3

55. (B) Preserve trust in financial markets.

Explanation

Rules against insider trading and enforcement of laws regarding fraud and theft by corporate managers are intended to preserve trust in the markets of public investors. While clear and honest disclosure and fraud prevention are goals, limiting the downside risk of equities markets is not a likely objective of financial regulation. Neither is the education of unsophisticated investors.

(Study Session 11, Module 33.3, LOS 33.l)

Related Material

SchweserNotes - Book 3

56. (C) Limit buy order at 38 when the best bid is 39.

Explanation

A limit buy order is behind the market if its limit price is below the best bid. A limit sell order is behind the market if its limit price is above the best ask. Market orders are never said to be behind the market.

(Study Session 11, Module 33.3, LOS 33.h)

Related Material

SchweserNotes - Book 3