

Reading 68**DERIVATIVE INSTRUMENT &
DERIVATIVE MARKET FEATURES**

1. (B) are illiquid.

Explanation

Derivatives that trade on exchanges have good liquidity in most cases. They have the other characteristics listed.

(Module 68.1, LOS 68.b)

2. (A) The investor will have a gain on the forward contract when the price of the shares of Jaffrey falls.

Explanation

The investor is a forward seller and therefore, has a short exposure to the Jaffrey shares with respect to the forward contract. When the price of Jaffrey falls (rises), the investor gains (loses) on the forward contract.

(Module 68.1, LOS 68.a)

3. (B) a gain on the forward contract.

Explanation

For an interest rate forward contract, a higher interest rate means gains for the buyer. In contrast, higher interest rates mean lower bond prices and losses for the buyer of a bond forward contract.

(Module 68.1, LOS 68.a)

4. (B) \$0.

Explanation

The forward price is set so that the forward contract has zero value to both parties at contract initiation; neither party pays at the initiation of the contract.

(Module 68.1, LOS 68.a)

5. (A) based on another security, commodity, or index.

Explanation

A derivative is a security the value of which is derived from the value of some other underlying asset. Some derivatives trade on organized exchanges. The price at which a transaction will (or may) take place in the future is stated in a derivatives contract.

(Module 68.1, LOS 68.b)

6. (B) cash-settled contract.

Explanation

A cash-settled contract specifies that only the net gain or loss from the forward contract is exchanged at settlement.

Although the amount is netted, the contract is not called a "netted contract". A deliverable contract requires that the payment and shares be exchanged at the settlement date.

(Module 68.1, LOS 68.a)

7. (C) Transaction costs for a derivatives position are often lower than for the equivalent cash market trade.

Explanation

Investors can gain exposure to risk at relatively low cost, effectively creating a highly leveraged investment in the underlying. Initiating a derivatives position is most likely to have a lesser impact on market prices of the underlying, relative to initiating an equivalent position in the underlying through a cash market transaction.

(Module 68.1, LOS 68.a)

8. (C) guarantee that all obligations by traders will be honoured.

Explanation

The central clearinghouse does not originate trades, it acts as the opposite party to all trades. In other words, it is the buyer to every seller and the seller to every buyer. This action guarantees that all obligations under the terms of the contract will be fulfilled.

(Module 68.1, LOS 68.b)

9. (B) act as guarantor to both sides of a futures trade.

Explanation

Acting as the counterparty for all buyers and sellers is the primary role of the clearinghouse. By providing liquidity, the clearinghouse may also help lower transaction costs indirectly.

(Module 68.1, LOS 68.b)

