

FREE SERIES 66 PRACTICE EXAM

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1. A technical analyst states that the market is “consolidating”, which means that the market is:
 - A. Going up
 - B. Going down
 - C. Moving sideways
 - D. Reversing an upward trend

2. If an investor expects the market value of his stock to go sideways, he can increase his yield by:
 - I. Buying calls
 - II. Selling calls
 - III. Buying Puts
 - IV. Selling Puts
 - A. II and IV
 - B. I and III
 - C. II and III
 - D. I and IV

3. If a mutual fund charges a 12b-1 distribution fee, which of the following are true:
 - A. The fund is always a no-load
 - B. The fund is always a load fund
 - C. The fund is always sold through broker/dealers
 - D. The distribution fee is an expense charged to the shareholders

4. All of the following are false about REITs, EXCEPT:
 - A. They must distribute at least 90% of their net investment income as dividends
 - B. At least 60% of their gross income must be from real estate investments
 - C. They are open-end investment companies
 - D. They are limited partnerships

5. A customer enters an order to buy stock at the best available price. He does not specify a price and expects the order to be executed as soon as possible. This is a:
 - A. Market order
 - B. Limit order
 - C. Stop order
 - D. A stop-limit order

6. A dealer on the floor of an exchange who is responsible for maintaining a fair and orderly market and managing a book of unexecuted stop and limit orders is known as a:
- A. Floor broker
 - B. Market maker
 - C. Specialist
 - D. Floor trader
7. All of the following may be done in a cash account EXCEPT:
- A. Buying options
 - B. Buying stock
 - C. Selling a stock short
 - D. Buying mutual funds
8. ADRs represent ownership of which of the following:
- A. Foreign securities traded in foreign markets
 - B. Foreign securities traded in U.S. markets
 - C. U.S. securities traded in foreign markets
 - D. U.S. securities traded in U.S. markets
9. A state issues a bond to build a road. Users of the road will pay tolls, which will be used to pay off the bond issue. What type of bond is this:
- A. General obligation bond
 - B. Corporate bond
 - C. Revenue bond
 - D. Debenture
10. Which of the following securities has no fixed maturity date:
- A. Debenture
 - B. Preferred stock
 - C. Municipal bond
 - D. Treasury bill
11. Which of the following corporate securities is most senior:
- A. Common stock
 - B. Preferred stock
 - C. Debenture
 - D. Mortgage bond

12. An investor bought 100 shares of stock in January of 2004 for \$20 a share and sold the stock in August of 2004 for \$30 a share. Assuming the investor is in a 25% tax bracket, how much tax would be due:
- A. \$150
 - B. \$200
 - C. \$250
 - D. \$280
13. In 2004, an investor owned 1000 shares of stock that paid annual dividends of \$1.00 per share and also owned 20 corporate bonds that paid interest at the nominal rate of 5%. Assuming the investor is in a 25% tax bracket and held the securities all year, how much tax would be due:
- A. \$300
 - B. \$400
 - C. \$500
 - D. \$750
14. All of the following are characteristics of preferred stock EXCEPT a:
- A. Ownership position in the company
 - B. Fixed, guaranteed rate of return
 - C. No maturity date
 - D. Priority over common stock regarding dividends and liquidation
15. All are characteristics of high yield bonds EXCEPT:
- A. High volatility
 - B. Often purchased by fiduciaries
 - C. High nominal interest rates
 - D. Generally unsecured
16. A convertible bond has a conversion ratio of 10. The common stock that it is convertible into is selling in the market for \$125 a share. What is the parity price of the bond:
- A. \$1,000
 - B. \$1,250
 - C. \$1,500
 - D. \$1,750
17. A convertible bond has a conversion ratio of 20. The bond is selling in the market for 80. What is the parity price of the stock:
- A. \$20
 - B. \$40
 - C. \$50
 - D. \$80

18. Municipal bonds are generally considered “tax-exempt”, which means that:
- A. Interest is exempt from state and federal income tax
 - B. Interest is exempt from state income tax
 - C. Interest is exempt from federal income tax
 - D. Capital gains are exempt from federal income tax
19. An investor buys shares of an open-end mutual fund in January of 2004, when the NAV is \$14 and the ASK price is \$15. The investor redeems his shares in August of 2004, when the NAV is \$19 and the ASK price is \$20. What is his tax implication:
- A. Long-term capital gain of \$5 per share
 - B. Long-term capital gain of \$6 per share
 - C. Short-term capital gain of \$4 per share
 - D. Short-term capital gain of \$5 per share
20. Under the Investment Company Act of 1940, all of the following are considered to be “management” companies EXCEPT a:
- A. No-load open-end mutual fund
 - B. Diversified closed-end mutual fund
 - C. Non-diversified open-end front load mutual fund
 - D. Unit investment trust
21. When the market price of a stock is \$50, an investor buys a call option contract on the stock with a strike or exercise price of \$50 for a premium of \$2. If the stock goes up in value to \$60, what is the contract’s “intrinsic” value:
- A. \$0
 - B. \$800
 - C. \$1,000
 - D. \$1,200
22. Which of the following option positions are considered to be “bullish”:
- I. Long call
 - II. Short call
 - III. Long put
 - IV. Short put
- A. I only
 - B. III only
 - C. II and III
 - D. I and IV
23. Which type of investment generates tax deferred income:
- A. Variable annuities
 - B. Mutual funds
 - C. Stocks
 - D. Bonds

24. In the OTC market, the difference between a market maker's bid and ask prices is known as the:
- A. Commission
 - B. Spread
 - C. Mark-up
 - D. Mark-down
25. On a corporate balance sheet, retained earnings represent:
- A. Shareholder's equity
 - B. Capital surplus
 - C. Undistributed net income
 - D. Working capital

ANSWERS & RATIONALES

1. **C** A “consolidating” (or neutral) market is said to be moving sideways, not up or down.
2. **A** If a stock’s market price remains relatively constant, it is said to be going “sideways”, which means neither up nor down. So, this investor should be selling options, because they will probably expire unexercised and the investor can keep the premiums, which have the effect of increasing his yield.
3. **D** Both load and no-load funds can charge 12b-1 distribution fees. However, if the distribution fee exceeds $\frac{1}{4}$ of 1% of net assets, the fund cannot call itself a no-load. The distribution fee trails along as an expense to shareholders year after year, which has the effect of lowering their yields.
4. **A** Real estate investment trusts are more similar to closed-end investment companies, in that they issue a fixed number of shares that trade in the secondary market based upon supply and demand. However, the IRC requires REITs to distribute at least 90% of their net investment income to avoid double taxation while 75% of a REITs income must be from real estate. They are not considered to be limited partnerships, since losses do not flow through directly to the investors.
5. **A** A market order has no specified price, and will be executed at the market price immediately, meaning as soon as possible. Most orders are market orders.
6. **C** A specialist is charged with maintaining a fair and orderly market in specified stocks so that investors can buy or sell without causing prices to change dramatically. He stands ready to buy or sell for his own account in order to keep the auction market going. He also manages the book of unexecuted limit and stop-loss orders, which consist of open orders placed away from the current market price of the stock.
7. **C** Options may be purchased either in a cash account or a margin account, but since they have no loan value, they must be fully paid for in cash on the settlement date. However, all short sales of stock must be done in a margin account. Open-end mutual funds must be purchased in a cash account, since new issues sold in the primary market are not marginable.
8. **B** An ADR (American depository receipt) is a receipt for the shares of a foreign-based corporation held in the vault of a U.S. bank and entitling the shareholder to all dividends and capital gains. Instead of buying shares of foreign companies in overseas markets, Americans can buy shares in the U.S. in the form of an ADR, which facilitates the trading of those foreign securities.
9. **C** Municipal governments generally issue either general obligation bonds, which are backed by taxes, or revenue bonds, which are backed by user fees paid by the users of the facility. Unsecured corporate bonds are also known as debentures.

10. **B** A debenture is just another name for an unsecured corporate bond, which are often issued to mature in 30 years. While municipal bonds are long-term and T-bills are short-term, they both have fixed maturity dates. However, both common and preferred stock is issued without any maturity date, so the issuing corporation never has to repay the shareholder their invested capital. Remember, stock is equity, while bonds are debt.
11. **D** Seniority, or “priority”, has to do with the preferential ranking of security holders regarding the distribution of corporate assets upon corporate dissolution. Of course, the preferred stock holders have priority over the common shareholders, but even the worst bond has priority over the best stock. So, a mortgage bond, which is backed by real estate held as collateral by the bond’s trustee, has seniority over a debenture, which is unsecured.
12. **C** Although recent tax law changes lowered the long-term capital gains tax rate to 15% for investors in higher tax brackets, this is a short-term capital gain, which is taxed as ordinary income. So, 25% of the investor’s \$1,000 short-term gain is \$250.
13. **B** Under current tax law, qualified dividends paid to taxpayers in higher tax brackets are taxed at the same rate as net capital gains, which is now 15%, so the tax due on the dividends would be 15% of \$1,000, or \$150. However, bond interest is still taxed as ordinary income. Remember, the nominal rate of 5% is a percentage of the bond’s par value, which is \$1,000. So, since the investor owns \$20,000 worth of bonds that pay interest at the rate of 5%, his interest total \$1,000, which is taxed at his ordinary income tax rate of 25%. 25% of \$1,000 is \$250. $\$250 + \150 equals \$400.
14. **B** Although preferred dividends are not guaranteed, if paid, they are paid at the fixed rate specified on the stock certificate. Ownership of preferred stock does represent an equity position in the corporation and is senior to common stock. However, neither common nor preferred has a fixed maturity date.
15. **B** High yield (or “junk”) bonds must pay high nominal interest rates in order to attract investors. Their volatility is usually substantially higher than investment grade bonds, and fiduciaries are often prohibited from buying them under the Prudent Investor Act. They are unsecured debentures that are rated BB or lower, due to their increased risk of default.
16. **B** A conversion ratio of 10 means that this bond is convertible into 10 shares of common stock of the same issuer at the discretion of the bondholder. Since the stock is worth \$125 a share, the “parity” price of the bond is \$1,250. Parity means “equal”.
17. **B** This bond is convertible into 20 shares of common stock of the same issuer. If the bond is selling in the market for 80 (meaning \$800), 20 shares of stock worth \$40 would be equal to (or at parity with) the value of the bond. If the stock is selling for more than \$40, the investor should convert the bond. Remember, the conversion ratio is fixed, but parity changes.
18. **C** Municipal bond interest is exempt from federal income tax no matter which state the investor lives in. However, if an investor living in Arizona buys a California municipal bond, the interest will be subject to Arizona state income tax. In order for the bond to be “double exempt”, the investor must live in the same state as the issuer. Capital gains resulting upon the sale of municipal bonds are taxable.

19. **C** When you buy open-end mutual fund shares, you pay the ASK price, which in this case was \$15. When you redeem the shares, the fund must pay you the NAV (or “bid” price), which in this case was \$19, so the capital gain is \$4 per share. Since the investor held the shares for less than one year, it is a short-term gain, which is taxed as ordinary income.
20. **D** A unit investment trust (UIT) is an investment company, but since a UIT is unmanaged, they are not management companies. Generally, UITs are formed by brokerage firms who sell units of a trust, who in turn invests the money in a fixed portfolio of bonds that generate a stream of interest payments. However, all mutual funds, whether they are open-end, closed-end, diversified or non-diversified are considered to be management companies, since they pay a fee to an investment advisor to manage their portfolios.
21. **C** Intrinsic value is also known as the “in the money” amount. On a call option, when the market price of the underlying stock goes above the strike or exercise price, the option is said to be in-the-money, since it has built in, or inherent value. In this case, the call option has intrinsic value of \$10 a share, or \$1,000, since there are 100 shares in a contract. In other words, this contract may be sold on the CBOE for at least \$1,000, since whoever owns it could exercise the contract and buy the stock for \$50 and immediately sell the stock in the market for \$60. Intrinsic value does not include the premium.
22. **D** Remember, a “short” position is one the investor sold or borrowed. A “long” position is one the investor owns or is buying. Buying a call is considered “bullish”, in that an investor will make money if the underlying stock goes up. Selling a put is also “bullish”, in that the investor will make money (the premium) if the stock goes up, since the buyer of the put will allow it to expire unexercised.
23. **A** Unless investing is done within a “qualified plan”, such as an IRA, tax deferred income is hard to come by. However, even though most variable annuities are non-qualified, they do generate tax deferred earnings during their accumulation period. In other words, all income is automatically reinvested in the separate account and is free from tax until distribution, when earnings above the investor’s cost basis are taxed as ordinary income.
24. **B** Commissions are charged by brokers when executing agency transactions on behalf of their customers. Although OTC market makers (or dealers) do charge mark-ups when selling out of their inventory to customers, and mark-downs when buying for their inventory from customers, the difference between their quoted bid and ask prices is known as the “spread”. Generally, the more active the market on a stock, the narrower (closer) the spread will be.
25. **C** The balance sheet equation states that Total Assets minus Total Liabilities equals Net Worth. Net worth is also known as shareholder’s equity. The components of shareholder’s equity include: 1) retained earnings; 2) the value of the preferred stock at par; 3) the value of the common stock at par; and 4) paid-in capital (which is also known as capital surplus). Paid-in capital represents monies that the company initially received for selling their new stock for more than its stated par value. Retained earnings consist of the undistributed net income of the corporation.