

FREE SERIES 7 OPTIONS PRACTICE EXAM

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1. Mr. Booker is short 400 shares of UTC at 50. If UTC declines to 32, all of the following are methods to protect his unrealized gain EXCEPT:
 - A. Buy 4 35 calls
 - B. Enter a buy 400 at 34 stop GTC
 - C. Write 4 30 puts
 - D. Write 4 35 calls

2. The writer of an equity option is assigned an exercise notice. He:
 - A. Must fulfill the contract by delivering the underlying security if it was a put or taking delivery if it was call.
 - B. Must fulfill the contract even if the underlying security has stopped trading on the principal exchange.
 - C. Can offset his obligation by writing a call if the option was a put.
 - D. Has the choice of doing a closing transaction or fulfilling the contract.

3. Which two of the following option positions are of the same class?
 - I. 1 LET April 40 put and 1 LET July 30 put
 - II. 1 LET April 40 call and 1 LET July 30 call
 - III. 1 LET April 40 call and 1 LET April 30 put
 - IV. 1 LET April 40 call and 1 LET July 40 put
 - A. I and II only
 - B. I and IV only
 - C. II and III only
 - D. III and IV only

4. What percentage of the purchase price must a buyer of a listed option pay?
 - A. 25%
 - B. 30%
 - C. 50%
 - D. 100%

5. Which of the following should you recommend to a client who holds a large portfolio of equity securities and wishes to enjoy further gains while at the same time protecting his profits?
- I. Write calls
 - II. Buy calls
 - III. Write puts
 - IV. Buy puts
- A. I or III
 - B. II
 - C. II or IV
 - D. I or IV
6. The option premium is:
- A. The profit made on the option
 - B. The amount paid for the option over par
 - C. The cost of the option
 - D. The amount received by the holder of the option
7. Which of the following is the most frequent reason for buying calls?
- A. Anticipation of a dividend
 - B. A bullish outlook for the underlying stock
 - C. An attempt to hedge against increased taxes
 - D. A bearish outlook for the underlying stock
8. An investor who is bullish on a stock would probably:
- A. Write a call
 - B. Buy a put
 - C. Buy a call
 - D. Sell the stock short against the box

Questions 9 - 11 refer to the following information.

A customer with no other securities positions sells 1 ABC October 25 put for a premium of \$2, when the price of ABC stock is \$25 per share.

9. The day before expiration, what is the stock price per share at which the writer will breakeven?
- A. \$23
 - B. \$25
 - C. \$27
 - D. \$29

10. What is the maximum loss the writer could sustain just before expiration?
- A. \$200
 - B. \$2,300
 - C. \$2,500
 - D. \$2,700
11. What is the maximum gain the writer could sustain just before expiration?
- A. \$200
 - B. \$2,300
 - C. \$2,500
 - D. An unlimited amount
12. If Mr. Goodman saw himself as a bullish investor, he might consider which two of the following strategies?
- I. Call buying
 - II. Call writing
 - III. Put buying
 - IV. Put writing
- A. I and III
 - B. I and IV
 - C. II and III
 - D. II and IV
13. A customer purchased at par a 10% municipal bond due 6/1/08. The bond has an annual put option at par. Which of the following statements is false?
- A. The option will probably be exercised if yields rise sharply
 - B. The option cannot be exercised without the issuer's consent
 - C. The yield will not be below 10%
 - D. The option will affect the market price
14. If a client is holding equity securities and wants to protect her profits from a decline in the stock, she should:
- A. Write calls
 - B. Write puts
 - C. Buy calls
 - D. Buy puts
15. A client writes an April 50 put for 6 in December and is exercised on April 7. If 8 weeks later the client sells the same stock for \$52 a share, the client would have made which of the following?
- A. An \$800 capital loss
 - B. An \$800 capital gain
 - C. A \$200 capital loss
 - D. A \$200 capital gain

16. If a customer was seeking income from a "blue chip" stock portfolio, which of the following options strategies would be the most appropriate?
- A. Spreading calls or puts
 - B. Covered put writing
 - C. Uncovered put writing
 - D. Covered call writing
17. Which of the following types of listed option transactions is considered to be the most speculative?
- A. Sale of a spread position
 - B. Sale of an uncovered call
 - C. The purchase of a long call
 - D. The purchase of a spread position
18. A short call in a margin account can be covered by which of the following?
- I. An escrow receipt
 - II. A convertible bond
 - III. A long call on the same security
 - IV. The underlying stock
- A. I and II
 - B. II and III
 - C. I, II and IV
 - D. I, II, III and IV
19. If a customer writes a covered call, that customer:
- A. Buys a similar call
 - B. Is short the underlying stock
 - C. Is long the underlying stock
 - D. Must buy the underlying stock if the option is exercised
20. All of the following will cover a put writer in a margin account EXCEPT:
- A. If she is long the underlying stock
 - B. If she is short the underlying stock
 - C. If she deposits cash equal to the exercise price of the put
 - D. If she owns a put on the same stock with at least as long of an expiration date and at least as high an exercise price.

21. A customer writes one BFD June 40 put and deposits the exercise price with his broker when the underlying security is at 40. If the market price rises to 50, how much additional cash must the customer deposit with his broker?
- A. Zero dollars
 - B. \$250
 - C. \$500
 - D. \$1,800
22. Which of the following could not be used to cover short call options in a cash account?
- A. Escrow receipts
 - B. The underlying stock
 - C. Convertible bonds
 - D. Bank guarantee letter
23. Which of the following is true regarding an October 110 call on a British pound when it is valued at 115 if the premium is 7?
- A. Has intrinsic value
 - B. Is out-of-the-money
 - C. Trades at parity
 - D. Has no time value
24. Which of the following is correct concerning a March 130 British pound call option trading at 6 when the British pound is valued at 125?
- A. It has no time value
 - B. It is out of the money
 - C. It has intrinsic value
 - D. It is trading at parity
25. Which two of the following investors would not lose if the strike price of an option and the market price of the underlying stock remained the same?
- I. The buyer of a straddle
 - II. Seller of a straddle
 - III. Buyer of an at-the-money put
 - IV. Seller of an at-the-money put
- A. I and III only
 - B. I and IV only
 - C. II and III only
 - D. II and IV only

Answers & Rationales

1. **D** Writing an uncovered call is not a method of protecting anything. Writing an uncovered call has an unlimited risk to it.
2. **B** If the writer of an equity option is assigned an exercise notice, the writer has no choice but to deliver or buy the underlying security even though it may have stopped trading on the principal exchange. The writer does not have an additional option of closing his position after it has been exercised.
3. **A** Options of the same class are all calls or all puts on the same underlying stock. Roman numeral I has two puts on the same stock so they are the same class, and Roman numeral II has two calls on the same stock so they are of the same class.
4. **D** Buying of options on margin is prohibited. 100% of the premium amount must be deposited.
5. **D** This client wants to enjoy further gains, but also protect profits. The further gains may be accomplished by writing the calls because the client will receive the premium while at the same time her profits will be protected by buying the put.
6. **C** The buyer/holder of the option pays the premium which is his cost of the option.
7. **B** If an investor were bullish on a particular stock, he could either buy the stock or buy calls on the stock.
8. **C** An investor who is bullish on a stock expects the price of the stock to go up and would purchase a call on the stock.
9. **A** $\$25 - \$2 \text{ premium received} = \23 .
10. **B** The put writer must buy the stock at the exercise price of 25. If the price goes to 0, he could lose \$2,500 minus the \$200 received as a premium, or \$2,300.
11. **A** If the option is not exercised, the writer will keep the premium of \$2 per share, or \$200.
12. **B** A bullish investor expects the market to go up and in anticipation of this increase, would buy calls and sell puts (put writing).
13. **B** If an investor has a put option privilege, the put option may be exercised at the discretion of the holder and does not need the permission of the issuer upon exercise.
14. **D** Since the investor is long equity securities, the danger to the investor is a decline in price that would cause a loss of profits. One way to hedge this long position is to buy puts and exercise the puts at the exercise price if the price of the stock declines.

15. **B** In order to determine capital gain or loss, it is very important to know what the customer's basis is. Since the customer in this question was exercised at 50, that means that the customer must buy the stock for \$50 a share or \$5,000. But since the customer received a premium of \$6 a share or \$600, he really only paid \$4,400 (\$5,000 minus \$600). He sold the stock for 52 or \$5,200, thus, his gain is the difference between the \$4,400 and the \$5,200 for a total of \$800 capital gain.
16. **D** The writer of an option receives the premium and thus receives additional income. Since put options require the writer to pay for securities, if exercised, call writing would be most appropriate for customers seeking income from a "blue chip" portfolio.
17. **B** Since the call is uncovered, if the writer is exercised, he will have to go out into the marketplace to purchase the security for delivery. Since the price the writer will pay for the security is theoretically unlimited, this is a very speculative transaction.
18. **D** When an investor has a short call in a margin account, he has given another person the right to buy his stock from him. Naturally, it would be covered by the underlying stock and anything that can be converted into the underlying stock. All four items would cover a short call.
19. **C** One way that the writer of a call can be covered is to own the underlying stock. Long is a term which indicates that the customer owns the item. Thus, the customer would be covered if he is long the underlying stock.
20. **A** Choices (B), (C) and (D) will cover a put writer. However, owning the underlying stock will not cover the writer because when a writer is exercised, the writer must buy the stock, not deliver the stock.
21. **A** No additional cash is required if an option writer is covered. The writer of a put can be covered by depositing the exercise price with his broker. If the customer is exercised, he will have to purchase the securities from the buyer or holder. The money deposited with the broker will be used for this purchase.
22. **D** The writer of a call option can be covered in a cash account by owning the underlying stock, convertible bond, or an escrow receipt.
23. **A** Since the call exercise price is 110 and the British pound is valued at 115, it is correct to say that the option is in-the-money, aka, has intrinsic value. Note: Intrinsic value has nothing to do with the premium paid by the option purchaser.
24. **B** A call option contract is out of the money when the market value is below the strike price. Remember, do not look at in or out of the money from the customer's point of view, only from the contractor's point of view.
25. **D** Sellers of options, whether they be puts, straddles, or any other combination, make money when the purchaser does not exercise because they get to keep the premium amount. Since the strike price and the market price of the underlying stock remained the same, the purchaser would not exercise.