



PAST QUESTIONS AND ANSWERS (December 2006)

PAPER 7

FINANCIAL MARKETS

of

The Licensing Examination
for Securities and Futures Intermediaries

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Methodology of Developing Questions

Our Institute is committed to providing questions of the highest quality.

Our current examination structure has been benchmarked against those in both developed and emerging markets such as UK, US, Australia, Singapore, Malaysia and China. The syllabuses, study materials, training guides and questions were designed by international consultants specializing in financial education.

The Licensing Examination has been approved by the Academic and Accreditation Advisory Committee of the Securities and Futures Commission (SFC) as recognized industry qualification and local regulatory framework paper for meeting the competence requirements of the SFC.

External consultants are appointed to develop new questions according to specified criteria approved by our Examinations Committee. The aim of these criteria is to ensure that the candidates have thorough understanding of the manuals by testing them at different cognitive levels such as recall, comprehension, application, analysis and evaluation on predetermined weightings of each topic. The new questions are reviewed by reviewers who are market practitioners, legal and compliance professionals, and academics to ensure that the knowledge tested is covered in the study manuals, and that the standard of the questions is appropriate and consistent throughout.

To maintain their quality, the questions undergo frequent reviews and revisions internally which take into account, among others, the average correctness of the questions (i.e., the percentage of candidates in the examination who correctly answer the questions) and candidates' comments, if any, following each examination. In addition to the quality assurance being imposed on the questions, external assessors who are market practitioners, legal and compliance professionals, and academics, are engaged to conduct regular reviews. There are also periodic comprehensive reviews by external consultants on the manuals and questions.

The study manuals and their subsequent updates are the only source of materials for the setting of the questions, so that candidates need to study only those manuals and updates to prepare for the examinations.

It is estimated that the study manuals will require 6 to 11 hours of study time per topic, depending on which paper it is. Candidates may need to spend more or less time, depending on their work experience and background. They are advised to use the Learning Outcomes for each topic as a key to the way they study the materials in each topic, and unless explicitly stated, they could be tested on any aspect of the syllabus.

**Please attempt ALL 60 questions in this question book.
All questions carry EQUAL MARKS.**

<1>.

What did the Barings Case in 1995 highlight as being a necessity for financial institutions?

- A Strictly control derivatives trading and ensure traders have the necessary experience and skill.
- B Clearly segregate duties of employees and ensure transparency of reporting lines.
- C Employ senior supervisory personnel to be based in all subsidiary companies.
- D Ensure that minimum liquidity levels are maintained in order to cope with large derivative exposures.

<2>.

Which of the following is **NOT** a duty of fund managers?

- A To develop investment strategies.
- B To provide financial advisory services to individual investors.
- C To analyse the economic and corporate information.
- D To provide performance records of the investment portfolio.

<3>.

Bernard is 23 years old. He is a marketing executive and has relatively little free cash available for investment. Bernard is single and does not expect to marry in the next ten years. Which of the following is the **MOST LIKELY** investment objective of Bernard?

- A Capital growth.
- B Capital preservation.
- C Capital protection.
- D Capital stabilisation.

<4>.

Which of the following statements **BEST** describes an arbitrage activity?

- A To buy Stock A at a low price and to sell it later at a higher price in order to make a profit.
- B To buy and to sell fixed income securities with different durations along the yield curve in order to obtain a zero net transaction cost.
- C To buy a security in Hong Kong and, at the same time, to sell that security in London in order to capture the pricing differential between the two markets.
- D To buy Stock A and, at the same time, to buy a put option on Stock A in order to minimise the impact due to price changes.

<5>.

Assume that both business spending and industrial production are decreasing, and the general economic growth is contracting. Which stage of the economic cycles does this **MOSTLY LIKELY** represent?

- A Peak to contraction.
- B Contraction to trough.
- C Trough to expansion.
- D Expansion to peak.

<6>.

Which of the following statements about managed funds in Hong Kong is **INCORRECT**?

- A They are indirect investments.
- B They are not allowed to hold more than 15% of the ordinary shares issued by a single issuer.
- C They are managed on a discretionary basis.
- D They have pre-set investment objectives and strategies.

<7>.

Which of the following is **NOT** a commodity derivative?

- A Coffee options.
- B Credit options.
- C Silver futures.
- D Pork belly futures.

<8>.

Which of the following is **NOT** a type of financial risk?

- A Pure risk.
- B Credit risk.
- C Market risk.
- D Systemic risk.

<9>.

Which of the following relationships is explained by the principle of “purchasing power parity”?

- A The relationship between short-term interest rates and long-term interest rates.
- B The relationship between interest rates and exchange rates.
- C The relationship between interest rates and equity prices.
- D The relationship between the interest rates and property prices.

<10>.

Which of the following statements is **INCORRECT** about the brokerage houses that facilitate trading of securities and futures in Hong Kong?

- A Firms conducting securities/futures dealing activities must be licensed by or registered with the Securities and Futures Commission (SFC).
- B The term “brokerage houses” includes securities/futures brokers and dealers, securities margin financiers and investment advisers.
- C All individuals of a brokerage house whose duties involve securities/futures dealing activities must be licensed by or registered with the SFC.
- D Authorised institutions which are under the Hong Kong Monetary Authority’s (HKMA’s) supervision are exempted from registering with the SFC for carrying out securities/futures trading/dealing activities.

<11>.

An analyst has the following estimation on SHP’s return profile:

<u>Return</u>	<u>Probability</u>
?	20%
12%	50%
18%	30%

If the expected return of SHP is 13%, at the probability of 20%, SHP’s return is:

- A 6%.
- B 7%.
- C 8%.
- D 9%.

<12>.

What is the **PRIMARY** advantage of dividend reinvestment plans for the **ISSUER** of securities?

- A They enable a reorganisation of the corporate balance sheet.
- B They are a source of ongoing equity finance.
- C They reduce the number of shareholders.
- D They increase the number of shareholders.

<13>.

Which of the following statements is **CORRECT** regarding investing in equity securities versus debt securities?

- A On liquidation of a company, equity investors have primary claim of the company's assets.
- B Investing in equity securities always has higher yields than in debt securities on an annual basis.
- C Equity investors have potential of sharing the profit of a company.
- D Equity investors receive dividend payment before interest payments are made to debt investors.

<14>.

Which of the following is **NOT** an example of debt securities?

- A Exchange Fund Notes.
- B Corporate bonds.
- C Floating rate notes.
- D Options.

<15>.

A listed company in Hong Kong with a plan of building a theme park in Macau issues a large block of shares and sells to a few high net worth individuals. Which of the following equity financing methods is the company **LIKELY** to be using?

- A A bonus issue.
- B An Initial Public Offering.
- C A rights issue.
- D A private placement.

<16>.

The activity of consolidating and repackaging relatively illiquid assets into more liquid securities is generally known as:

- A debt restructuring.
- B securitisation.
- C trading.
- D liquidation.

<17>.

Exchange rate controls may cause an economic contraction. Which of the following is a **POSSIBLE** reason?

- A It discourages local consumption.
- B It increases the profitability of foreign companies.
- C It reduces foreign trade and investment.
- D It increases the wage burden of local employers.

<18>.

Which of the following is/are feature(s) of equity securities?

- I It is evidence of ownership.
 - II Its value depends on the profitability of the business.
 - III Holders may receive dividend payments.
 - IV Fixed coupons are paid to the holders periodically.
-
- A IV only
 - B II and III only
 - C I, II and III only
 - D I, II, III and IV

<19>.

Which of the following regarding a fixed rate exchange system is **CORRECT**?

- A The value of a currency fluctuates according to the market demand and supply.
- B The value of a currency is determined by the central bank.
- C The volatility of a currency fluctuates according to the market demand and supply.
- D The volatility of a currency is determined by the central bank.

<20>.

Which of the following was a **PRIMARY** cause of the Asian financial crisis of 1997-98?

- A A decrease in trade with the region.
- B Short-term, speculative capital outflows from the region.
- C A United States-led recession.
- D Political instability in the region.

<21>.

Which of the following statements about international capital flows is/are **INCORRECT**?

- I International flow of capital is facilitated by innovations in derivative products.
 - II International flow of capital is facilitated by liberalisation of financial markets around the world.
 - III International flow of capital can have significant impact on international markets, but not on domestic markets.
 - IV Financial liberalisation has no impact on the growth of international flow of capital.
-
- A II only
 - B III and IV only
 - C I, II and IV only
 - D I, II, III and IV

<22>.

Which of the following methods can be used by the government to influence the level of interest rates?

- I Intervention in the foreign exchange market.
 - II Changing government expenditure and taxation policies.
 - III Buying and selling government securities in the interbank market.
 - IV Imposing strict controls on the lending operations of financial institutions.
-
- A I and III only
 - B I, II and IV only
 - C II, III and IV only
 - D I, II, III and IV

<23>.

Why is financial advising frequently referred to as a “dynamic” concept?

- A It is always exciting and interesting to work in the industry.
- B Client objectives are constantly changing.
- C There are many different styles of financial advising depending upon the individual financial advisor.
- D The industry is constantly evolving with new participants and new techniques.

<24>.

In Hong Kong, which of the following is/are the **POSSIBLE** role(s) of a licensed bank?

- I To act as a financial intermediary.
 - II To provide capital to a corporation through a syndication.
 - III To regulate the activities of the financial market.
 - IV To take saving deposits from the general public.
-
- A I only
 - B I and II only
 - C III and IV only
 - D I, II, and IV only

<25>.

Which of the following about market risk is **INCORRECT**?

- A Assets held are susceptible to market risk.
- B Market risk can be reduced by diversifying across different asset types.
- C Market risk is caused by variations in asset prices.
- D Market risk can be eliminated by increasing market liquidity.

<26>.

In October 1983, the Hong Kong government adopted which of the following exchange rate systems in order to overcome the exchange rate instability?

- A The linked rate system.
- B The fixed rate system.
- C The floating rate system.
- D The gold standard system.

<27>.

Which of the following is **NOT** a reason why credit rating agencies are important in the risk management process?

- A They enhance transparency of the company.
- B They enhance accountability of the company.
- C They perform credit risk analysis of the company.
- D They perform internal audit for the company.

<28>.

In Hong Kong, when an authorised institution enters into a repurchase agreement with the Hong Kong Monetary Authority (HKMA) through the discount window, what type of financial instruments is **NORMALLY** used as collaterals?

- A Ordinary shares.
- B Exchange Fund Bills and Notes.
- C Equity derivatives.
- D Corporate debt securities.

<29>.

The Hong Kong Interbank Offer Rate (HIBOR) is **DIRECTLY** affected by which of the following factors?

- A The fluctuation of the Hang Seng Index.
- B The change in supply of the Hong Kong Dollar.
- C The change in real estate prices of Hong Kong.
- D The change in the London Interbank Offer Rate.

<30>.

In Hong Kong, which of the following regulatory bodies is responsible for granting licences to representatives who are involved in securities and futures dealing?

- A The Financial Services and the Treasury Bureau.
- B The Securities and Futures Commission (SFC).
- C The Hong Kong Monetary Authority (HKMA).
- D The Stock Exchange of Hong Kong (SEHK).

<31>.

Which of the following measures is designed to encourage the liquidity and activities of the debt market in Hong Kong?

- A Listing the Real Estate Investment Trusts on the Stock Exchange of Hong Kong (SEHK).
- B Allowing short selling activities of designated stocks on the SEHK.
- C Listing the Exchange Fund Notes on the SEHK.
- D Establishing the Growth Enterprise Market.

<32>.

In Hong Kong, which of the following regarding securities margin lending is **INCORRECT**?

- A It increases the risk of the investors.
- B Only blue chip stocks can be used as collateral in securities margin lending.
- C Investors have to bear additional interest cost.
- D It increases the activity and liquidity of the market.

<33>.

John holds 100 shares of TTT Corporation when a 1-for-4 bonus issue is announced. If the theoretical price of John's shares immediately after the bonus issue is HKD0.83, what is the share price immediately before the bonus issue?

- A HKD0.30
- B HKD0.83
- C HKD1.00
- D HKD1.04

<34>.

Which of the following is a benefit of securities margin financing?

- A Securities margin financing enhances the market liquidity of the stock market.
- B Securities margin financing provides a "level playing field" to small investors when compared to large institutional investors.
- C Securities margin financing lowers the risk of investing in the stock market as it is regulated by the Stock Exchange of Hong Kong (SEHK).
- D Securities margin reduces the systemic risk of the stock market.

<35>.

Which of the following instruments are listed on the Stock Exchange of Hong Kong (SEHK)?

- I Gold futures.
 - II Growth Equity Market (GEM) index futures.
 - III Exchange Fund Notes.
 - IV Real Estate Investment Trust.
-
- A I and IV only
 - B II and III only
 - C III and IV only
 - D II, III and IV only

<36>.

Which of the following is **NOT** an advantage of listing a company on a stock exchange?

- A To increase the capital base.
- B To increase the attractiveness of company's shares to investors.
- C To increase the corporate profile.
- D To increase the original owners' control over the company.

<37>.

In Hong Kong, the Securities and Futures Commission (SFC) requires which of the following financial market participants who give advice to the public to be licensed or registered?

- I Securities dealers.
 - II Securities traders.
 - III Salesperson of securities.
 - IV Financial commentators.
-
- A I and III only
 - B II and IV only
 - C I, II and III only
 - D I, II, III and IV

<38>.

Which of the following are **TYPICAL** specifications in a debt agreement?

- I The maturity of the debt.
 - II The academic qualifications of the borrower.
 - III The method of calculating interest.
 - IV The likelihood of default by the borrower.
-
- A I and III only
 - B I, II and IV only
 - C I, III and IV only
 - D I, II, III and IV

<39>.

In Hong Kong, which of the financing alternatives listed below is **NOT** classified as equity financing?

- A Rights issues.
- B Issuance of fixed income securities.
- C Retained Earnings.
- D Initial Public Offerings.

<40>.

Which of the following are measures taken to promote the debt securities market of Hong Kong?

- I Introduction of regulated short selling in debt securities by the Hong Kong Monetary Authority (HKMA).
 - II Establishment of the market-making system by the Securities and Futures Commission (SFC).
 - III The formation of the Hong Kong Mortgage Corporation Limited (HKMC) in 1997.
 - IV Tax exemptions on profits made from trading in certain debt securities.
- A I and II only
 - B III and IV only
 - C II, III and IV only
 - D I, II, III, and IV

<41>.

What is the annual interest rate of a deposit if a total interest of \$1,000 is earned from a deposit of \$10,000 over a period of 5 years with no reinvestment on interest earned?

- A 1.9% p.a.
- B 2.0% p.a.
- C 5.0% p.a.
- D 10.0% p.a.

<42>.

Which of the following products is **NOT** an example of a derivative?

- A Mortgage backed securities.
- B Warrants.
- C Equity-linked notes.
- D Structured notes.

<43>.

The interest rate of a 1-year deposit in Australian Dollar (AUD) is 6.0% p.a. and the interest rate of a 1-year deposit in Euro (EUR) is 3.5%. If the 1-year forward rate between AUD and EUR is quoted at AUD1.6468 per EUR, what is the spot rate of AUD per EUR?

- A 1.5701
- B 1.5950
- C 1.6080
- D 1.6866

<44>.

In Hong Kong, the Hong Kong Futures Exchange Clearing Corporation Limited acts as a counter-party for which of the following financial products during the settlement process?

- I Equity warrants.
- II Futures.
- III Options.
- IV Exchange traded funds.

- A I and IV only
- B II and III only
- C I, II and III only
- D II, III and IV only

<45>.

Country A allows its currency to be bought and sold freely in the foreign exchange market without any restrictions. However, when its currency fluctuates excessively, the central bank of Country A will step in to lower its volatility. Which of the following descriptions regarding Country A's exchange rate regime is **CORRECT**?

- A It is a fixed exchange rate regime.
- B It is a dirty floating exchange rate regime.
- C It is a linked exchange rate regime.
- D It is an exchange rate regime adopted by the Hong Kong Monetary Authority (HKMA).

<46>.

Which of the following is/are feature(s) of over-the-counter derivatives?

- I No standardised contract specifications.
- II Contracts are novated in settlement.
- III Less flexible to meet investors' needs.
- IV Settlement risk is lower than exchange-traded derivatives.

- A I only
- B I and II only
- C II and III only
- D II, III and IV only

<47>.

Through which of the following mechanisms can a normal retail investor minimise market risk of his investments?

- A Hedging.
- B Speculation.
- C Securitisation.
- D Swapping.

<48>.

John buys a basket of stocks which mirrors weighting of the Hang Seng Index (HSI). At the same time, John sells some HSI futures contracts which have the same value as the basket of stocks he has just bought. After completing these transactions, John expects to capture a risk-free profit when those HSI futures contracts expire. Based on the above information, in what type of trading activity is John **MOST LIKELY** engaged?

- A Speculation.
- B Swap.
- C Hedging.
- D Arbitrage.

<49>.

Which of the following statements regarding risk are **CORRECT**?

- I Systemic risk refers to risk pertaining to the fundamentals of a system as a whole.
 - II Reputation risk refers to the potential damage to a company's reputation.
 - III Market risk refers to the potential loss incurred due to default of counter-parties.
 - IV Operational risk refers to the potential of loss due to faults in the operation processes.
-
- A I and III only
 - B II and IV only
 - C I, II and IV only
 - D I, II, III and IV

<50>.

Which of the following are good corporate governance processes of a bank?

- I Establishing written policies and procedures regarding the composition and powers of the board of directors.
 - II Setting credit limits to control the credit exposures.
 - III Establishing specialist sales team for high net worth customers.
 - IV Setting investment limits to control the types of allowable investment.
- A I and II only
 - B I and III only
 - C II and IV only
 - D I, II and IV only

<51>.

Which of the following **BEST** describes the “risk-based supervisory approach” adopted by the Hong Kong Monetary Authority (HKMA) for financial market supervision in Hong Kong?

- A It disciplines financial institutions whose risk levels exceed the HKMA’s accepted level.
- B It supervises the risk levels of financial institutions on a daily basis.
- C It requires market participants to report the risk factors affecting their operations.
- D It establishes a regulatory framework to ensure that financial institutions it regulates possess appropriate risk management systems and processes.

<52>.

Which of the following statements about risk is **INCORRECT**?

- A Risk may contribute to desirable outcomes.
- B Risk management involves the efforts of reducing the downside risk.
- C Risk is unavoidable in many businesses operations because the future is uncertain.
- D The concept of risk management is to eliminate all types of risk.

<53>.

Information on two securities is given below:

	Security A	Security B
Expected return (μ)	15.00%	15.00%
Variance (σ^2)	0.0009	0.0036
Standard deviation (σ)	3.00%	6.00%

Which of the following statements about the concept of risk and return is **INCORRECT**?

- A The expected return of Security A has a tighter cluster around the mean, implying that it is less risky than Security B.
- B The expected return of Security B has a tighter cluster around the mean, implying that it is less risky than Security A.
- C Security B is riskier than Security A owing to a larger variance but having the same mean as Security A.
- D Security A has a lower risk than Security B for having a relatively smaller standard deviation but the same expected return.

<54>.

Which of the following statements regarding novation is/are **CORRECT**?

- I Novation is a process through which a clearing house acts as a counter-party for every transaction.
 - II Novation is a process through which a company issues a new security to investors.
 - III Novation is a process through which the levels of market and credit risk are decreased.
 - IV Novation is a process through which the creditability of a contract is enhanced.
- A I only
 - B I and IV only
 - C II and III only
 - D III and IV only

<55>.

Winnie is 31 years old and plans to have her first child in the following 18 months. When setting up a family financial plan with her husband, which of the following factors should they take into consideration?

- I Winnie's current income level and the stability of her job.
- II The plan of having a baby in the foreseeable future.
- III The nature and income prospect of Winnie's husband.
- IV The ages of Winnie and her husband.

- A I and IV only
- B I, II and III only
- C II, III and IV only
- D I, II, III and IV

<56>.

Brilliance Technologies is a company which provides web-based software solutions to corporate users in various industries. In the last ten years, the company has grown from a small team of software engineers to a multi-billion dollar business. Which of the following is **LIKELY** to be a contribution of corporate finance to the success of the company?

- A The development of the software which is well accepted by its clients.
- B Raising of sufficient capital to finance its growth in business.
- C The recruitment of talented workers to support its new business expansion.
- D Maintenance of good customer relations.

<57>.

Under normal circumstances, which of the following statements concerning the asset management industry is **MOST LIKELY** to be **INCORRECT**?

- A Investment funds are managed by a team of investment professionals under the predetermined investment objectives.
- B Investment made by a large mutual fund in a particular company may indicate its confidence in that company.
- C Investment funds with larger investment sizes usually take more risky investment strategies.
- D Investment funds spread their investments over a number of securities to reduce the risk of their portfolios.

<58>.

When a financial advisor establishes a financial plan for his client, which of the following should be included in the plan?

- A The financial goals of the clients and the strategies to meet such goals.
- B The guaranteed return of the plan in the investment horizon.
- C The background and experience of the financial advisor.
- D The recommended brokers for executing the plan.

<59>.

Ms Chin is 49 years old and has accumulated considerable wealth. She decides to seek professional advice on how to ensure a stable cash flow.

Based on Ms Chin's circumstances, what is **MOST LIKELY** to be her objective?

- A Long-term equity growth.
- B Short-term equity growth.
- C Wealth creation.
- D Wealth protection.

<60>.

Which of the following are services of a corporate finance professional provided to a listed company?

- I Providing advice on the financial structure of the company.
 - II Providing a syndication loan for the company.
 - III Providing advice on a merger of the company.
 - IV Carrying out valuation of the company.
-
- A I and III only
 - B I, II and IV only
 - C I, III, and IV only
 - D II, III and IV only

~End of the Examination Paper~

Answers

Question No.	Answer	Question No.	Answer	Question No.	Answer
1	B	21	B	41	B
2	B	22	D	42	A
3	A	23	B	43	C
4	C	24	D	44	B
5	A	25	D	45	B
6	B	26	A	46	A
7	B	27	D	47	A
8	A	28	B	48	D
9	B	29	B	49	C
10	D	30	B	50	D
11	C	31	C	51	D
12	B	32	B	52	D
13	C	33	D	53	B
14	D	34	A	54	D
15	D	35	C	55	D
16	B	36	D	56	B
17	C	37	C	57	C
18	C	38	A	58	A
19	B	39	B	59	D
20	B	40	B	60	C