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Practice Questions

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1. Which economic theory holds that business cycles are caused primarily by changes in the money supply and credit conditions rather than real sector shocks?

A. Real Business Cycle theory
B. Austrian Business Cycle theory
C. Keynesian demand-pull theory
D. Supply-side theory

2. Under the Uniform Securities Act, an investment adviser representative owes which primary duty to clients?

A. Fiduciary duty to act in the client's best interest
B. Suitability duty to recommend reasonable products
C. Duty to maximize commissions within legal limits
D. Duty to follow broker-dealer instructions above client interests

3. Under the Investment Advisers Act of 1940, investment advisers owe clients a fiduciary duty. Which of the following BEST describes what that duty requires?

A. Recommending only securities that generate the highest commission for the adviser
B. Recommending securities suitable for the client's general risk tolerance only
C. Acting in the client's best interest and placing the client's interests ahead of the adviser's own
D. Disclosing all compensation after a transaction has been completed

4. Which type of stock gives its holders priority over common stockholders when dividends are declared?

A. Preferred stock
B. Growth stock
C. Value stock
D. Blue-chip stock

5. Under the Uniform Securities Act, which of the following persons is defined as an 'investment adviser'?

A. A person who provides advice about securities for compensation
B. A broker-dealer who executes securities transactions for clients
C. A person who only publishes general market newsletters without giving individualized advice
D. A trust company that manages assets under a court order

6. Modern Portfolio Theory (MPT) was developed primarily to show that:

A. Individual stock selection determines nearly all portfolio returns
B. Diversification eliminates both systematic and unsystematic risk
C. Combining assets with low correlations can reduce portfolio risk without sacrificing expected return
D. The optimal portfolio always holds the market portfolio alone

7. Which of the following is the PRIMARY factor an investment adviser must consider when making a recommendation to a client?

A. The client's specific investment objectives and financial situation
B. The commission the adviser will earn on the transaction
C. The historical performance of the recommended security
D. The current market trend for the asset class

8. An investor allocates 60% of a portfolio to equities and 40% to bonds. This division between asset classes is best described as:

A. Asset allocation
B. Security selection
C. Market timing
D. Tactical rebalancing

9. Which type of security is specifically designed to protect investors against inflation risk?

A. Corporate bonds
B. Municipal bonds
C. Zero-coupon bonds
D. Treasury Inflation-Protected Securities (TIPS)

10. A registered investment adviser who also acts as a broker-dealer must disclose this dual capacity to clients primarily because:

A. FINRA requires separate registration for each role
B. State regulators prohibit dual registration entirely
C. The dual role creates a conflict of interest the fiduciary must disclose
D. Clients must pre-approve each individual transaction

11. Which of the following is NOT a component of an investment adviser's fiduciary duty to a client?

A. Guaranteeing positive investment returns
B. Acting with loyalty toward the client
C. Providing full and fair disclosure of material conflicts of interest
D. Exercising due care when managing client assets

12. An investor who owns common stock has which of the following rights?

A. The right to receive a fixed dividend
B. The right to a guaranteed return of principal
C. The right to vote on major corporate matters
D. The right to priority over bondholders in liquidation

13. Under the Uniform Securities Act, which of the following is EXCLUDED from the definition of 'broker-dealer'?

A. A firm that executes trades on behalf of retail customers
B. An agent who effects transactions only for the firm's own account
C. A firm that underwrites new securities offerings
D. A market maker in listed securities

14. Unsystematic risk is best described as:

A. Company-specific or industry-specific risk that can be eliminated through diversification
B. Risk associated with broad market movements that cannot be diversified away
C. The risk that interest rates will rise, reducing bond prices
D. Inflation risk that affects all asset classes equally

15. An investment adviser representative (IAR) discovers that a 70-year-old retired client's portfolio is 95% allocated to speculative penny stocks. What should the IAR do FIRST?

A. Immediately liquidate all penny stocks without consulting the client
B. Leave the portfolio unchanged to respect client autonomy
C. Review the client's current investment profile and discuss whether the allocation still meets the client's objectives
D. Report the situation to FINRA before taking any action

16. Tactical asset allocation (TAA) differs from strategic asset allocation primarily because TAA:

A. Sets fixed weights that never change
B. Ignores the investor's time horizon entirely
C. Temporarily deviates from target weights to exploit short-term market opportunities
D. Always reduces equity exposure when volatility rises

17. When the Federal Reserve raises the discount rate, the most direct immediate effect is:

A. Borrowing from the Fed becomes more expensive for banks
B. Consumer mortgage rates automatically fall
C. The money supply immediately increases
D. Treasury bond yields fall

18. An investment adviser representative recommends a mutual fund that pays the highest 12b-1 fee to the firm without disclosing this arrangement to the client. This is BEST described as a violation of:

A. The suitability rule because the fund was not suitable
B. The fiduciary duty because a material conflict was not disclosed
C. The anti-money-laundering rules because unreported income was received
D. FINRA Rule 2010 because the rep lacks good character

19. The duty of loyalty requires an investment adviser to:

A. Prioritize the firm's profitability when managing client portfolios
B. Put the client's interests ahead of the adviser's own interests
C. Disclose only conflicts that the adviser believes are material
D. Execute all trades at the best available price regardless of commissions

20. A company has 8% cumulative preferred stock outstanding and skips its dividend for two consecutive years. Before any common dividend can be paid, the preferred stockholders must receive:

A. 8% of the current year's dividend only
B. 24% covering all three years' arrears plus the current year
C. 8% for the current year and nothing for prior years
D. 16% covering the two skipped years only

21. An agent who terminates employment with one broker-dealer and immediately joins another must:

A. File a new Form U4 only with FINRA within 30 days
B. Surrender the existing registration, which automatically transfers
C. Promptly notify the Administrator and file a new registration or transfer
D. Wait 90 days before effecting any transactions at the new firm

22. Which term describes the statistical measure that indicates how two securities move in relation to each other?

A. Standard deviation
B. Correlation coefficient
C. Beta
D. Alpha

23. When gathering client information to assess suitability, which of the following is LEAST relevant?

A. Client's tax bracket
B. Client's favorite investment guru
C. Client's time horizon
D. Client's liquidity needs

24. A client's portfolio has drifted from its target 70/30 equity/bond split to 78/22 after a strong equity rally. Restoring the portfolio to 70/30 is best described as:

A. Profit taking
B. Sector rotation
C. Tax-loss harvesting
D. Rebalancing

25. Which of the following relationships between interest rates and bond prices is correct?

A. When interest rates rise, bond prices rise proportionally
B. Bond prices and interest rates move in the same direction
C. Long-term bonds are less sensitive to interest rate changes than short-term bonds
D. When interest rates rise, existing bond prices fall

26. Under the Investment Advisers Act, an investment adviser must deliver Form ADV Part 2 to prospective clients:

A. Within 30 days after the advisory contract is signed
B. Only upon client request after the initial meeting
C. Once per year regardless of contract status
D. At or before entering into an advisory contract

27. An investment adviser's duty of care requires which of the following?

A. Ensuring each recommendation results in a profit for the client
B. Providing advice based on a reasonable inquiry into the client's financial situation and investment objectives
C. Disclosing all personal financial holdings to the client
D. Charging the lowest possible fee in the market

28. Convertible preferred stock is MOST likely to trade closest to its conversion value when:

A. Interest rates rise sharply
B. The company's earnings decline significantly
C. The preferred dividend is in arrears
D. The underlying common stock price is well above the conversion price

29. Which of the following persons is EXEMPT from registration as an investment adviser under the Uniform Securities Act?

A. A person who charges fees for advising clients on municipal bonds
B. A sole proprietor giving personalized stock recommendations for a flat annual fee
C. A firm that advises pension funds on equity allocations for compensation
D. A bank holding company that advises only bank clients and has no office in the state

30. The efficient frontier represents portfolios that:

A. Offer the highest possible return regardless of risk
B. Have zero standard deviation
C. Minimize return for any given level of risk
D. Maximize expected return for each level of portfolio risk

Answer Key & Explanations

1. B — Austrian Business Cycle theory
Austrian Business Cycle theory attributes booms and busts to credit expansion by central banks that distort interest rates and lead to malinvestment. Real Business Cycle theory attributes cycles to technology shocks.

2. A — Fiduciary duty to act in the client's best interest
Investment adviser representatives are fiduciaries and must place client interests ahead of their own. This is a higher standard than the suitability standard that applies to broker-dealers.

3. C — Acting in the client's best interest and placing the client's interests ahead of the adviser's own
The fiduciary standard requires an adviser to act in the client's best interest and prioritize the client's interests over the adviser's own. This is a higher standard than mere suitability and requires ongoing loyalty and care.

4. A — Preferred stock
Preferred stockholders receive dividends before common stockholders and have a senior claim on assets in liquidation. Growth, value, and blue-chip are categories of common stock.

5. A — A person who provides advice about securities for compensation
The USA defines an investment adviser as any person who, for compensation, engages in the business of advising others on securities. Broker-dealers, publishers of general newsletters, and trust companies acting under court orders are excluded from this definition.

6. C — Combining assets with low correlations can reduce portfolio risk without sacrificing expected return
MPT, introduced by Markowitz, demonstrates that combining assets whose returns are not perfectly correlated lowers portfolio variance without necessarily reducing expected return. It does not eliminate systematic risk, only unsystematic risk.

7. A — The client's specific investment objectives and financial situation
Suitability and, under Reg BI, best interest standards require that recommendations be based primarily on the client's own investment objectives, risk tolerance, time horizon, and financial situation—not the adviser's compensation or market trends.

8. A — Asset allocation
Asset allocation is the strategic decision of how to divide a portfolio among broad asset classes such as equities, bonds, and cash. Security selection refers to picking individual securities within an asset class.

9. D — Treasury Inflation-Protected Securities (TIPS)
TIPS have their principal adjusted by changes in the CPI. As inflation rises, the principal increases, so interest payments (a fixed percentage of adjusted principal) also rise, protecting purchasing power.

10. C — The dual role creates a conflict of interest the fiduciary must disclose
As a fiduciary, an investment adviser must disclose all material conflicts of interest, including acting as both

adviser and broker-dealer on the same transaction, because this could influence recommendations.

11. A — Guaranteeing positive investment returns
Fiduciary duty consists of duties of loyalty, care, and disclosure — but never includes guaranteeing returns. Promising guaranteed returns is actually prohibited under securities law.

12. C — The right to vote on major corporate matters
Common shareholders have voting rights on matters such as electing the board of directors. Common stock pays no fixed dividend and ranks behind both bondholders and preferred shareholders in liquidation.

13. B — An agent who effects transactions only for the firm's own account
Under the USA, 'broker-dealer' excludes agents who effect transactions solely for the account of the broker-dealer itself. An individual acting only as the firm's trader is not a broker-dealer.

14. A — Company-specific or industry-specific risk that can be eliminated through diversification
Unsystematic (diversifiable) risk stems from factors specific to a firm or industry—such as a product recall or management scandal—and can be reduced by holding a diversified portfolio.

15. C — Review the client's current investment profile and discuss whether the allocation still meets the client's objectives
The IAR's first duty is to reassess suitability by reviewing and updating the client's investment profile. Only after confirming or clarifying the client's current objectives and risk tolerance can appropriate action be recommended.

16. C — Temporarily deviates from target weights to exploit short-term market opportunities
Tactical asset allocation deliberately overweights or underweights asset classes relative to long-term targets to capitalize on perceived short-term opportunities, then reverts when the opportunity closes.

17. A — Borrowing from the Fed becomes more expensive for banks
The discount rate is what the Fed charges banks for short-term loans at the discount window. Raising it makes emergency borrowing from the Fed more costly, encouraging banks to seek funds elsewhere and generally tightening credit.

18. B — The fiduciary duty because a material conflict was not disclosed
Recommending products that benefit the adviser without disclosure violates the fiduciary duty of loyalty. The conflict of interest (12b-1 compensation) is a material fact that must be disclosed to the client.

19. B — Put the client's interests ahead of the adviser's own interests
The duty of loyalty means the adviser must subordinate its own interests to those of the client. Any conflict of interest must be disclosed and either eliminated or managed to protect the client.

20. B — 24% covering all three years' arrears plus the current year
Cumulative preferred stock requires that all accumulated unpaid (in arrears) dividends must be paid before any common dividend is declared. Two skipped years plus the current year equals three years × 8% = 24%.

21. C — Promptly notify the Administrator and file a new registration or transfer
When an agent changes employers, the agent and both broker-dealers must promptly notify the state Administrator. A new registration or transfer must be filed; registrations are not automatic.

22. B — Correlation coefficient
The correlation coefficient (ranging from -1 to +1) quantifies the degree to which two securities' returns move together. A value of -1 means perfect inverse movement; +1 means perfect synchrony.

23. B — Client's favorite investment guru
Suitability analysis focuses on objective financial data such as tax situation, time horizon, liquidity needs, and risk tolerance. A client's preferred commentator or guru is a preference with no direct bearing on suitability.

24. D — Rebalancing
Rebalancing is the process of realigning portfolio weights back to the investor's target asset allocation after market movements have caused them to drift.

25. D — When interest rates rise, existing bond prices fall
Bond prices and interest rates have an inverse relationship. When market rates rise, existing bonds paying lower coupons become less attractive, so their prices fall. Long-term bonds are MORE sensitive (higher duration) to rate changes, not less.

26. D — At or before entering into an advisory contract
Advisers must deliver their brochure (Form ADV Part 2) to clients before or at the time of entering into the advisory contract, giving clients an opportunity to review the adviser's practices and conflicts.

27. B — Providing advice based on a reasonable inquiry into the client's financial situation and investment objectives
The duty of care obligates advisers to conduct a reasonable investigation into each client's circumstances before making recommendations, ensuring advice is appropriate for that specific client.

28. D — The underlying common stock price is well above the conversion price
When the common stock trades well above the preferred's conversion price, arbitrage forces the preferred's market price to track the value of the common shares it converts into, making the conversion value the dominant pricing factor.

29. D — A bank holding company that advises only bank clients and has no office in the state
The USA exempts investment advisers that have no place of business in the state and whose only in-state clients are financial institutions such as banks. The other choices describe persons meeting the full definition of investment adviser.

30. D — Maximize expected return for each level of portfolio risk
The efficient frontier is the set of portfolios that provide the highest expected return for each unit of risk (standard deviation). Portfolios below the frontier are suboptimal because a better risk-return combination is available.

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