

Equity Compensation Strategies

Module 1 Exam

This document provides the Module 1 exam for the *Equity Compensation Strategies* course of study. The exam is based on material appearing in the 2009 and earlier editions of the book *Equity Compensation Strategies*. Further information is available at www.fairmark.com/ecs.

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Please fill out this evaluation form and submit it with your answer sheet.

	Strongly disagree				Strongly agree
Content was relevant	1	2	3	4	5
Learning objectives were met	1	2	3	4	5
Content was current and accurate	1	2	3	4	5
Explanations were clear	1	2	3	4	5
I would recommend to others	1	2	3	4	5

Time required to complete this module, including reading, study and completion of the exam (response does not affect hours of credit): _____

Comments/suggestions:

Equity Compensation Strategies

Module 1 Answer Sheet

Please Print Legibly

Office Use
Date _____
Score _____

Name: _____

Company: _____

Address: _____

City, State, ZIP: _____

Telephone: _____

Email: _____

Notify company upon successful completion: _____

Payment: Check enclosed Online payment invoice # _____

Credit card # _____ Exp: _____

Name on card _____

Billing address _____

Circle your response to each question

- 1. A B C D
- 2. A B C D
- 3. A B C D
- 4. A B C D
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 - 27. A B C D
 - 28. A B C D
 - 29. A B C D
 - 30. A B C D
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Equity Compensation Strategies

Module 1 Exam Questions

- Which of the following correctly describes a restricted stock unit?
 - Stock that is subject to Rule 144.
 - Stock received now that will vest in the future.
 - A right to receive stock in the future.
 - Stock that does not pay dividends.
 - Your client's options are in the money. This means:
 - The option has a built-in profit.
 - Your client will not need cash to exercise the option.
 - The option is under water.
 - The stock value is the same as the exercise price.
 - Your client's options are vested. This typically means:
 - The company cannot terminate the option.
 - Your client can keep the option after employment terminates.
 - Your client can exercise the option.
 - Your client has already paid tax on the option.
 - For a stock option plan, which of the following is a true statement about the prospectus?
 - It imposes limits on options that may be granted under the plan.
 - It is intended as a description of the plan.
 - It is approved by the company's shareholders.
 - This is another name for the plan document.
 - In determining whether it is appropriate for your client to take the risk associated with a particular strategy, which of the following would NOT be a significant consideration?
 - Your client's risk tolerance.
 - The degree to which your client's overall wealth is exposed to the company's stock.
 - Analysis indicating the company's stock is likely to perform well or poorly.
 - The impact a loss would have, based on considerations such as your client's age and financial obligations.
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6. Your client holds a large position in stock that has been determined to have a volatility of 60%. Which of the following statements is accurate?
- A. This stock should move up and down about 60% as much as the overall stock market.
 - B. The stock price is unlikely to fall more than 60% in a given year.
 - C. There is a 60% chance the stock price will move significantly up or down.
 - D. A concentrated holding in this stock will involve far more risk than a well diversified stock portfolio.
7. Which of the following is a requirement for your client to diversify his portfolio effectively?
- A. Investments should be predominantly in companies that compete with the company where your client works.
 - B. Investments should be predominantly in industries where your client has enough familiarity to make a knowledgeable selection.
 - C. Investments should include stocks from many different sectors of the economy.
 - D. Investments should include short positions that balance long positions.
8. Which of the following is an accurate statement about an investment strategy that involves compensated risk?
- A. A better result is reasonably certain.
 - B. Any losses should be offset by gains.
 - C. The risk is associated with a higher expected return.
 - D. Someone is paying the investor to take the risk.
9. Your client holds nearly all her wealth in the stock of a single company. She is considering selling some of the shares to diversify into other stocks. Which of the following is an accurate statement about diversification?
- A. Diversification would leave her overall risk unchanged, but spread the risk among different assets.
 - B. Diversification can reduce overall risk, but your client generally will have to accept a smaller expected return when she diversifies.
 - C. Diversification can reduce the portion of risk that is not compensated.
 - D. Full diversification would virtually eliminate risk.
10. Your client exercised an option and decided to hold the stock, which is now trading at \$30. Your client can bear the risk of some loss, but must sell as soon as possible if the price falls below \$20, because otherwise she may be unable to pay her income tax. Assuming there are no restrictions on her ability to sell shares, what kind of order should she place with her broker?
- A. A market order.
 - B. A stop order.
 - C. A limit order.
 - D. None, because she has to wait until the stock price falls below \$20.
11. A transaction in which your client exchanges the economic performance of shares of stock for the economic performance of another financial instrument is called which of the following?
- A. A constructive sale.
 - B. A notional principal contract.
 - C. A variable forward sale.
 - D. A qualified covered call.

12. If your client holds shares of stock, which of the following would your client do to create a collar on that position?
- A. Buy two put options with different strike prices.
 - B. Buy two call options with different strike prices.
 - C. Buy a call option and a put option.
 - D. Buy a put option and sell a call option.
13. Which of the following would be a major reason to avoid a tight collar when hedging appreciated shares?
- A. It may be treated as a constructive sale.
 - B. It may be treated as a notional principal contract.
 - C. It exposes your client to too much economic risk.
 - D. The cost of a tight collar is likely to be prohibitive.
14. Which of the following is an accurate statement about stock that is restricted under Rule 144?
- A. It is not possible to sell these shares.
 - B. It is possible to sell the shares, but any profit on the sale must be disgorged.
 - C. The shares are not considered vested for tax purposes until the restriction is removed.
 - D. A sale transaction may involve added expense and some delay.
15. Your client informs you that his shares are subject to Rule 701. Which of the following can you conclude based on this information?
- A. Your client may be able to sell the shares earlier than if they were subject to Rule 144.
 - B. Your client may have to wait longer to sell the shares than if they were subject to Rule 144.
 - C. Your client must disgorge any profits from selling these shares within six months after acquiring them.
 - D. These shares are exempt from any lockup period that may apply after an IPO.
16. Which of the following is a correct statement about Section 16 of the Securities Exchange Act of 1934?
- A. It treats your client as the owner of option shares even before your client exercises the option.
 - B. It allows your client to reduce or eliminate liability by identifying shares when selling them.
 - C. It normally applies to everyone who receives stock or options from the company.
 - D. It applies only to unregistered shares.

17. Your client has been informed that he is a Section 16 insider. Under these rules, which of the following will occur if he has a short-swing profit?
- A. Your client will have to treat the profit as ordinary income.
 - B. Your client will have to pay a 10% penalty in addition to the normal income tax.
 - C. Your client will have to disgorge the profit, but only if he acted on inside information.
 - D. Your client will have to disgorge the profit regardless of whether he acted on inside information.
18. Your client has three stock sales in the current year. One produced a short-term capital loss of \$5,000, another produced a short-term capital gain of \$4,000, and the other produced a long-term capital gain of \$3,000. How will the short-term capital loss apply in calculating your client's taxes for this year?
- A. It will apply first against the short-term capital gain, and then against ordinary income.
 - B. It will apply first against the short-term capital gain, and then against the long-term capital gain.
 - C. It will apply first against the long-term capital gain, and then against the short-term capital gain.
 - D. It will apply only against the short-term capital gain.
19. Your client exercised a nonqualified stock option, paying \$25,000 to buy shares worth \$225,000 and reporting \$200,000 of compensation income. The total amount your client paid to the company was \$78,000, which consists of the \$25,000 exercise price plus \$50,000 in income tax withholding and \$3,000 in social security tax. Your client's adjusted basis for the shares is:
- A. \$25,000.
 - B. \$78,000.
 - C. \$225,000.
 - D. \$278,000.
20. Your client exercised a nonqualified stock option and held the shares for a period of time, eventually selling for a price that was higher than the exercise price but lower than the value on the date of exercise. This situation can create a capital loss whipsaw in which your client:
- A. Reports ordinary income on one side of a transaction and capital loss on the other side of the same transaction.
 - B. Reports capital gain on one side of a transaction and capital loss on the other side of the same transaction.
 - C. Converts ordinary income into capital gain.
 - D. Gains an artificial tax benefit from capital losses.

21. According to the tax regulations, what must your client do to identify shares that are being sold?
- A. Give written instructions to the broker and receive written confirmation.
 - B. Give oral or written instructions to the broker and receive written confirmation.
 - C. Give oral or written instructions to the broker and receive oral or written confirmation.
 - D. Indicate on his tax return which shares he treated as sold.
22. Your client owns several blocks of shares of stock in the same company, bought at different times and different prices. If she sells some of the shares without identifying the ones sold, which shares must she report as sold for tax purposes?
- A. The shares acquired earliest.
 - B. The shares acquired most recently.
 - C. The shares with the highest basis.
 - D. The shares with the lowest basis.
23. Your client holds shares with a value of \$20,000 and an adjusted basis of \$80,000. He sells the shares to his brother for \$20,000. Which of the following accurately describes the tax consequences?
- A. Neither your client nor his brother can deduct the \$60,000 loss.
 - B. Your client can deduct the \$60,000 loss if the \$20,000 value was determined objectively.
 - C. Your client can deduct the \$60,000 loss if his brother sells the shares for \$20,000.
 - D. Your client's brother can deduct the \$60,000 loss if he sells the shares for \$20,000.
24. Your client sells shares at a loss on December 10. To avoid having a wash sale, your client must not have a purchase of replacement shares during what period?
- A. From December 10 to December 31.
 - B. From November 10 to December 31.
 - C. From December 10 to January 9.
 - D. From November 10 to January 9.
25. Your client has made many purchases and sales of stock in the company where he works, sometimes at a profit and sometimes at a loss. He also receives stock options from the company. Which of the following may trigger a wash sale, in the view of the IRS?
- A. The grant of an option but not the exercise of an option.
 - B. The exercise of an option but not the grant of an option.
 - C. The grant and exercise of the same option.
 - D. The grant or exercise of an option, but not both.
26. Your client acquired shares of stock that are fully vested. If the stock pays dividends, what dividends will qualify for the 15% rate?
- A. Only the dividends received after she holds the shares one year will qualify.
 - B. Only the dividends received after she holds the shares 61 days will qualify.
 - C. All dividends may qualify if she holds the shares one year.
 - D. All dividends may qualify if she holds the shares 61 days.

27. Which of the following is true for dividends paid during a period stock is not vested?
- A. If the stock is not vested, no dividend will be paid.
 - B. The dividend will be treated as compensation income.
 - C. The dividend will be investment income, but not eligible for the 15% rate.
 - D. The 15% rate will apply if the stock is held at least 61 days.
28. Your client is planning to sell stock that has declined in value. She has held the stock nearly a year, so she can choose to sell it now for a short-term loss or wait a few days and sell for a long-term loss. Which of the following is an accurate statement?
- A. Because it is a loss, it will not make any difference whether it is short-term or long-term.
 - B. Your client may be better off with a long-term loss.
 - C. Your client may be better off with a short-term loss.
 - D. If your client has a short-term loss, she can deduct it without regard to the \$3,000 capital loss limitation.
29. Your client holds a diversified portfolio of stocks, some of which are appreciated and some of which are depreciated. He can sell shares for tax purposes without undermining his investment strategy. Which of the following would be one of the guidelines for a sound tax strategy?
- A. He should seek to avoid recognizing losses.
 - B. He should seek to recognize losses that balance his gains.
 - C. He should seek to recognize losses that exceed his gains by no more than \$3,000.
 - D. He should seek to maximize recognition of tax losses.
30. Your client holds stock worth \$120,000 with tax basis of \$20,000. Her tax rate on the gain will be 15%. She is weighing a choice between selling the shares now or holding the shares an additional year. Which of the following accurately describes the benefit of tax deferral in this situation?
- A. It is equivalent to an interest-free loan of \$15,000 for one year.
 - B. It is equivalent to a tax-free investment of \$85,000 for one year.
 - C. It is equivalent to a tax-free investment of \$100,000 for one year.
 - D. It is equivalent to a tax-free investment of \$105,000 for one year.