1. The stock of Coakley Company has an ask price of 75. The bid-ask spread is 0.80.

Sammie buys 1000 shares of Coakley at the same time that Ross sells 1000 shares. Sammie pays a commission of 0.10 per share purchased. Ross pays a commission of 1% of the sales price.

Determine the total transaction costs incurred by Sammie and Ross combined.

Solution:

The ask price is the price that the buyer will pay.

The bid price is the ask price less the bid-ask spread so it is 75.00 – 0.80 = 74.20. This is the price the seller will get.

Transaction costs are Buyer Payment – Seller Payment =

\[ [(1000)(75) + (1000)(0.10)] - [(1000)(74.20)(1-0.01)] = 1642.00 \]
2. In a short sale of a stock, there is credit risk. Define credit risk.

Solution:
Credit risk is the risk that one party in a transaction will not honor the agreement.

How does a broker protect itself from credit risk in a short sale of a stock?

Solution:
A broker protects itself by requiring the seller to deposit the sales proceeds into a restricted account. This money is known as the collateral. Additionally, the broker requires the seller to deposit additional funds into the account. These additional funds are known as the haircut. The funds in the account are available if necessary to be certain that the seller will repurchase the stock at a later date.
3. There are four uses of derivatives. Please list those uses.

Risk Management or Hedging
Speculation
Reduce Transaction Costs
Regulatory Arbitrage