CHAPTER 7

ECONOMICS OF REGULATION

1. (A) may be susceptible to political pressures from members.

Explanation

SROs are SRBs that are given recognition and regulatory powers. SROs may be still subject to political pressure from their members. SROs when properly supervised by regulatory agencies have been effective in carrying out the objectives of the regulation and use of SROs in civil-law countries is not common.

(Module 7.1, LOS 7.f)

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2. (B) Regulations requiring the insurance of retail deposits at large banks may increase risk-taking incentives for the bank.

Explanation

Regulation has historically focused on the protection of retail investors. When investors work through intermediaries it introduces rather than reduces the agency problem. When bank deposits are insured, banks may adopt more aggressive risk-taking policies.

(Module 7.1, LOS 7.b)

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3. (C) both Singapore and Switzerland.

Explanation

Regulators in both countries can potentially block this acquisition. An analyst following the industry has to be aware of both countries' anti-trust regulations.

(Module 7.1, LOS 7.c)

Related Material

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4. (C) **A small investor is investigating a speculative stock and applies an incorrect growth estimate for the company's earnings.**

Explanation

Regulations are needed in the presence of information asymmetry externalities, weak competition, and social objectives. A privately held company seeking new equity investors would be in a situation where the company insiders have better quality information than the investors (i.e., information asymmetry). Street parking is a public good (i.e., an externality) which needs to be regulated for its optimal production and allocation. Incorrect growth estimates are subjective and not due to information asymmetry and hence would not be a valid justification for regulations.

(Module 7.1, LOS 7.a)

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5. (B) **a price mechanism regulatory tool.**

Explanation

Tax breaks on new equipment purchases are effectively government subsidies. Taxes and subsidies are examples of price mechanism regulatory tool.

(Module 7.1, LOS 7.g)

Related Material

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6. (B) **information asymmetry.**

Explanation

Management have greater knowledge than investors, a situation known as informational asymmetry which the independent audit seeks to address. Audits promote high quality financial reporting, which reduces the information asymmetry between management and investors. Externalities are costs and benefits affecting a party that did not choose to incur that cost or benefit. Externalities often lead to sub-optimal production decisions.

(Module 7.1, LOS 7.a)

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7. (B) **Statement 1 only.**

Explanation

Statement 2 is inaccurate: antitrust regulation seeks to address any anti-competitive behavior, including practices such as discriminatory pricing. Statement 1 is accurate as given.

(Module 7.1, LOS 7.e)

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8. (B) **Self-regulating bodies are recognized by the government.**

Explanation

Not all self-regulating bodies are regulators: SRBs are only regulators if they receive government recognition. In some countries, SRBs are never recognized by the government. Self-regulating organizations (SROs) differ from standard self-regulatory bodies in that SROs are given recognition and authority by a government body or agency. FINRA is an example of a self-regulating organizations (SROs); its purpose is to ensure that the securities industry operates fairly.

(Module 7.1, LOS 7.f)

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9. (B) **Requiring a company to pay a fine if annual financial statements are not filed in a timely fashion.**

Explanation

Fining the company would place the regulatory burden on the shareholders whom the regulation is intending to protect.

(Module 7.1, LOS 7.g)

Related Material

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10. (B) **Regulatory arbitrage**

Explanation

Regulatory arbitrage occurs when the firms exploit the difference between the economic substance and interpretation of a regulation. Regulatory capture occurs when the regulatory body gets influenced (or even controlled) by the regulated industry. Regulatory failure is not defined in the curriculum.

(Module 7.1, LOS 7.f)

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11. (A) **Airline**

Explanation

Reduction in subsidy would shrink food processors as their costs increase. Mining industry would shrink due to additional taxes. Airline industry would be relatively unaffected by new regulations (nothing in the question suggests impact on airline industry).

(Module 7.1, LOS 7.i)

Related Material

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12. (C) **direct costs of implementation, less private benefits resulting from implementation, plus the indirect cost of changes in economic behavior resulting from implementation.**

Explanation

Net regulatory burden measures direct and indirect costs against the private benefits resulting from implementation.

(Module 7.1, LOS 7.h)

Related Material

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13. (C) **reduce inefficiencies in the industry.**

Explanation

Regulation can increase the size of an industry, for example through the use of subsidies. Regulatory capture means that regulation can sometimes benefit the industry being regulated. However, regulation is also likely to introduce inefficiencies — such as the implicit government bailout guarantees of the financial sector which lead to credit spreads that do not fully reflect the credit risk.

(Module 7.1, LOS 7.i)

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14. (A) **Preserve integrity of stock exchanges.**

Explanation

Protecting domestic industries and restricting unfair competition are examples of purposes of regulating commerce. Preservation of integrity of stock exchanges is an example of regulating financial markets.

(Module 7.1, LOS 7.b)

Related Material

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15. (A) **independent regulator**

Explanation

Independent regulators are not government agencies, however they are granted authority by a government and do make some regulations. The IARP is not a government agency as it not funded by the government. Nor is it a self-regulating organization as it is not an organization that regulates its own members.

(Module 7.1, LOS 7.d)

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16. (A) **private benefits were underestimated.**

Explanation

The net regulatory burden is the difference between the regulatory burden and private benefits. Prior to implementation of the regulation, a potential net regulatory burden is estimated. A sunset clause requires regulators to use actual outcomes to see if the regulation should be renewed. This is a comparison between actual and estimated values. Only when private benefits are underestimated would the actual net regulatory burden be less than the estimated.

(Module 7.1, LOS 7.h)

Related Material

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17. (B) **regulatory arbitrage.**

Explanation

When a company chooses to relocate to a new jurisdiction to avoid regulation, this is an example of regulatory arbitrage. Regulatory capture leads to regulation intended to enhance the interests of regulated entities. Regulatory burden refers to the costs of regulation for the entity being regulated.

(Module 7.1, LOS 7.f)

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