Question 1

L2EC-PQ1413-1506

LOS: LOS-6770

Lesson Reference: Lesson 1: Economics of Regulation

Difficulty: hard

Which of the following is *least likely* to be deemed an unfair form of international competition?

- (selected) Country A allocating resources to goods and services for which development efforts are most effective, then exporting these goods into country B at a lower price than the domestic market price.
- Country A allocating resources to goods and services for which government provides subsidies, then exporting these goods into country B at a lower price than the domestic market price.
- Country A restricting the imports of cheap goods produced by country B.

Rationale

This Answer is Correct

International competition is deemed unfair when it is subsidized by an international government, then exported to other countries at an artificially low price. Answer A would not be unfair competition since economic theory supports the concepts of comparative advantage and free trade.

Question 2

L2EC-PQ1404-1506

LOS: LOS-6730

Lesson Reference: Lesson 1: Economics of Regulation

Difficulty: hard

Which of the following statements regarding self-regulating organizations is *most* accurate?

- ○ All self-regulating organizations are independent regulators.
- ● All self-regulating organizations enforce rules and standards on their members.
- ○ Self-regulatory organizations are always an important part of the regulatory framework of countries.

Rationale

This Answer is Correct

In order for self-regulatory organizations to be independent regulators they must have recognition and authority from a government body or agency. The use of self-regulatory organizations varies between countries, and sometimes can not feature at all in the regulatory framework of a country.

Question 3
L2EC-PQ1416-1506
LOS: LOS-6780
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
An international company that uses a common product and market strategy across several jurisdictions will *most likely* need to satisfy the anti-trust regulations of:

- ○ their domestic market only.
- ◉ all markets in which they do business.
- ○ an international regulator.

Rationale

This Answer is Correct

Companies that do business internationally are likely to have to satisfy the antitrust regulations of all the jurisdictions in which they do business simultaneously.

Question 4
L2EC-TB0011-1412
LOS: LOS-6720
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: medium
In the United States, the Securities and Exchange Commission (SEC) is an example of which of the following types of regulator?

- (selected) Government agency.
- Self-regulatory organization.
- Independent regulator.

Rationale

This Answer is Correct

The SEC is a government agency that regulates the securities markets in the United States. An independent regulator is recognized by a government regulator but is not a government agency itself. A self-regulating organization is an independent body that represents and regulates its members.

Question 5
L2EC-PQ1407-1506
LOS: LOS-6740
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
All of the following are examples of issues associated with informational frictions, except:

- ○ Adverse selection
- ○ Moral hazard
- ● Externalities

Rationale

This Answer is Correct

Informational frictions include “adverse selection” (private information in the hands of some, but not all market participants) and “moral hazard” (incentive conflict from the delegation of duties that will affect the behavior of one party to the detriment of another party). Whilst externalities such as the benefits of the production of a public good can affect regulatory policy, they are not issues with informational friction.

Question 6

L2R15TB-AC008-1512

LOS: LOS-6740

Lesson Reference: Lesson 1: Economics of Regulation

Difficulty: medium

Regulatory competition results in:

- (selected) competition between regulators to attract specific entities.
- informational friction and asymmetry.
- self-regulating organizations.

Rationale

competition between regulators to attract specific entities.

Regulatory competition results from government or regulator competition specific to attracting companies or other types of entities to establish operations within the regulator's jurisdiction relative to other locations.

Rationale

informational friction and asymmetry.

Regulatory competition results from government or regulator competition specific to attracting companies or other types of entities to establish operations within the regulator's jurisdiction relative to other locations.

Rationale

self-regulating organizations.

Regulatory competition results from government or regulator competition specific to attracting companies or other types of entities to establish operations within the regulator's jurisdiction relative to other locations.

Question 7
L2EC-PQ1411-1506
LOS: LOS-6760
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
Which of the following enforcement tools would be least appropriate for a regulator to use when imposing sanctions in response to corporate fraud?

- ○ Prison terms
- ○ Individual fines
- ◉ Corporate fines

Rationale

This Answer is Correct

In the case of corporate fraud, stockholders are the likely victims of the fraud. In such a case, it is unlikely to be a satisfactory sanction to punish those shareholders further by imposing corporate fines.

Question 8
L2EC-TB0013-1412
LOS: LOS-6740
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: medium
According to economic theory, which of the following markets would *most likely* benefit from regulatory intervention?

- ○ A “Pareto optimal” market.
- ○ A competitive market with constant returns to scale, no frictions, and no externalities.
- ◉ A market with informational frictions and externalities.

Rationale

This Answer is Correct

The case for regulatory intervention rests on the presence of informational frictions and externalities, which could cause agents to unfairly benefit at the expense of others or avoid facing the consequences of their actions. Answers A and B refer to the same form of theoretical market utopia where no informational efficiencies or frictions exist in the market, and hence, no regulatory intervention would be appropriate, since intervention would lead to a less efficient market.

Question 9
L2EC-TB0012-1412
LOS: LOS-6730
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: medium
Which of the following factors is *most likely* to favor reliance on self-regulating organizations (SROs) in a regulatory system?

- ◯ Privatization of securities exchanges.
- ◯ Internationalization.
- ◉ Use of knowledge and experience of industry professionals.

Rationale

This Answer is Correct

Answers A and B are reasons why regulatory systems are moving away from self-regulation over time as regulators have the ability to directly regulate private exchanges, and internationalization demands a consistent level of regulation. Self-regulation will directly use the knowledge and experience of industry professionals.

Question 10
L2EC-PQ1409-1506
LOS: LOS-6750
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
In the periods subsequent to a global financial crisis, it is often the case that regulations are tightened in areas that are deemed to have contributed to the conditions that led to the crisis. With respect to regulatory interdependencies, if country A tightens regulations sooner than country B, what is the *likely* outcome of these differences in regulatory regimes?

- ( ) Regulatory arbitrage will likely cause firms to shift in location to do business in country A.
- (•) Regulatory arbitrage will likely cause firms to shift in location to do business in country B.
- ( ) Increasing globalization will likely make it irrelevant where firms do business from a regulatory perspective.

Rationale

This Answer is Correct

Differences in regulatory approaches can lead to "regulatory competition," which can undercut the effectiveness of enhanced regulation in particular countries. If firms choose to do business in the location with least regulation, they will shift location to country B.

Question 11
L2R15TB-AC009-1512
LOS: LOS-6770
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: medium
Regulations in the financial sector are of significance because of the consequences of failure of the financial system, which include:

- (selected) loss of confidence.
- establishment of independent regulators.
- anticompetitive behavior.

Rationale
✔ **loss of confidence.**
Regulations are necessary and are extensive due to the consequences of failures in the financial system that can include: financial losses, loss of confidence, and disruption of markets, among other outcomes.

Rationale
✘ **establishment of independent regulators.**
Regulations are necessary and are extensive due to the consequences of failures in the financial system that can include: financial losses, loss of confidence, and disruption of markets, among other outcomes.

Rationale
✘ **anticompetitive behavior.**
Regulations are necessary and are extensive due to the consequences of failures in the financial system that can include: financial losses, loss of confidence, and disruption of markets, among other outcomes.

Question 12

L2EC-PQ1408-1506

LOS: LOS-6750

Lesson Reference: Lesson 1: Economics of Regulation

Difficulty: hard

"Regulatory capture theory" is best characterized as when:

- ◯ Regulated companies fight new proposed regulations.
- ◯ New regulations negatively affect industry profits.
- ◉ Regulation enhances the interests of the regulated.

Rationale

This Answer is Correct

"Regulatory Capture Theory" states that regulation can often arise, which enhances the interests of the regulated, for example, by increasing barriers to entry of the industry.

Question 13
L2R15TB-ITEMSET-AC001-1512
LOS: LOS-6750
LOS: LOS-6780
LOS: LOS-6790
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: medium

Use the following information to answer the next 3 questions:

A company operates in multiple geographic regions. It produces products in the Tsalal region where environmental regulations are limited. The company has also grown by purchasing competitors in the Leaplow region where there is limited government oversight over consolidations or acquisition-driven growth. An analyst reporting on the company reported:

> **Statement 1:** By maintaining factories in the Tsalal region, the firm is able to undercut its competitors who must meet more stringent environmental standards.
> **Statement 2:** The company has been acquiring competitors in the Leaplow region at a rapid pace, which will greatly improve its pricing power over.

i.
Statement 1 is an example of which type of interdependency between the regulated and the regulator?

- ○ Regulatory capture.
- ○ Regulatory competition.
- ● Regulatory arbitrage.

Rationale
This Answer is Correct
Regulatory arbitrage results from the identification and exploitation of regulatory difference to promote gain.

Rationale
This Answer is Correct
Regulatory arbitrage results from the identification and exploitation of regulatory difference to promote gain.

Rationale
This Answer is Correct
Regulatory arbitrage results from the identification and exploitation of regulatory difference to promote gain.

ii.
Evaluate Statement 2 under a U.S. regulatory framework. Would the company be subject to any additional scrutiny?

- ○ No.
- ● Yes, anticompetitive and antitrust laws.
- ○ Yes, collusive and monopolistic behavior.

Rationale

This Answer is Incorrect

Under U.S. regulations, the company's mergers and acquisitions would be reviewed to ensure that the outcome does not reduce competition or yield monopoly formation.

Rationale

This Answer is Incorrect

Under U.S. regulations, the company's mergers and acquisitions would be reviewed to ensure that the outcome does not reduce competition or yield monopoly formation.

Rationale

This Answer is Incorrect

Under U.S. regulations, the company's mergers and acquisitions would be reviewed to ensure that the outcome does not reduce competition or yield monopoly formation.

iii.

The economic rationale for regulation is to promote:

- ( ) transparency.
- (•) economic efficiency.
- ( ) informational friction and externalities.

Rationale

This Answer is Incorrect

Regulations are necessary because under some circumstances, the market is not adequate to meet the needs of all economic agents. Therefore, regulations promote economic efficiencies.

Rationale

This Answer is Incorrect

Regulations are necessary because under some circumstances, the market is not adequate to meet the needs of all economic agents. Therefore, regulations promote economic efficiencies.

Rationale

This Answer is Incorrect

Regulations are necessary because under some circumstances, the market is not adequate to meet the needs of all economic agents. Therefore, regulations promote economic efficiencies.

Question 14

L2EC-PQ1412-1506

LOS: LOS-6770

Lesson Reference: Lesson 1: Economics of Regulation

Difficulty: hard

The goal in regulating commerce can be best characterized as:

- ○ Promoting domestic competition and fair international competition.
- ○ Preventing domestic competition and unfair international competition.
- ◉ Promoting domestic competition and preventing unfair international competition.

Rationale

This Answer is Correct

In general, regulation of commerce focuses on preventing domestic anticompetitive behavior and unfair international competition.

Question 15
L2EC-PQ1401-1506
LOS: LOS-6720
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
In a regulatory framework, a statute is *most likely*:

- (selected) a law enacted by legislative bodies.
- a rule issued by regulatory bodies.
- an interpretation of a court of law.

Rationale

This Answer is Correct

Regulations can be classified as reflecting laws enacted by legislative bodies (Statutes), rules issued by government agencies or regulators (administrative regulations or administrative law), and interpretations of the courts (judicial law).

Question 16
L2EC-PQ1418-1506
LOS: LOS-6790
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
A “sunset provision” is best characterized as:

- ○ The requirement for regulators to enact trials in order to assess the costs and benefits of new proposed regulation.
- ◉ The requirement for a regulation to automatically be removed after a period of time unless a new cost/benefit analysis is performed by the regulator.
- ○ The requirement for regulators to consider the unintended consequences of proposed regulation prior to implementation.

Rationale

This Answer is Correct

The use of “sunset provisions” would lead to the automatic removal of a regulation after a given period of time unless the regulator assesses the impact of the regulation through a new cost/benefit analysis.

Question 17
L2EC-TBB209-1412
LOS: LOS-6750
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: medium
After a recent spate of high-profile corporate failures due to poor internal processes and corporate governance, regulators in country A have significantly tightened the listing and ongoing obligations for public companies. This tightening has not been mirrored in country B, and as such many companies based in country A are choosing to list their shares in country B. Which of the following statements regarding this scenario is most accurate?

- ○ The regulator in country A is engaging in regulatory competition.
- ○ The companies in country A are subject to regulatory capture.
- ◉ The companies in country A are engaging in regulatory arbitrage.

Rationale

This Answer is Correct

Regulatory competition describes the situation where a regulator attempts to provide a regulatory environment designed to attract certain entities. Regulatory capture refers to the situation where regulation arises, which enhances the interests of the regulated. Regulatory arbitrage occurs when entities exploit differences in economic substance across different regimes, which is occurring in this scenario.

Question 18
L2EC-PQ1402-1506
LOS: LOS-6720
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
When enacting regulatory policy, self-regulating organizations are *most likely* to be subject to pressure from:

- ○ The government
- ◉ Members of the organization
- ○ Both government and members of the organization

Rationale

This Answer is Correct

Self-regulating organizations are usually private, non-governmental organizations and as such will be largely independent of government, but may be subject to the pressure of their members.

Question 19
L2EC-PQ1420-1506
LOS: LOS-6800
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
Public disclosure of the fact that a financial institution accessed the “discount window” borrowing facility of the central bank is *most likely* to be advocated by:

- ○ the central bank.
- ○ the institution accessing the discount window.
- ● a financial news reporting company.

Rationale

This Answer is Correct

Use of the discount window of the central bank is likely to be information that the central bank will want to keep private in order to maintain orderly markets. The institution that used the facility will also likely resist public dissemination due to the stigma of accessing the lender of last resort. There have been historical cases of financial news companies enforcing freedom of information acts to uncover which institutions have accessed the central bank lending scheme.

Question 20
L2R15TB-ITEMSET-AC004-1512
LOS: LOS-6770
LOS: LOS-6730
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: medium

Use the following information to answer the next 3 questions:

Newly-hired analysts are asked to individually assess the following regulations as part of their one-day orientation at MCO Financial.

> **Regulation 1**: Companies are prohibited from making material disclosures to individual investors without providing the same information to the market at large.
> **Regulation 2**: Publically traded companies are required to reconcile non-GAAP financial measures with GAAP financial statements and measures.
> **Regulation 3**: Rating agencies require companies to provide financial data and access to financial ratings; the assessment of a company's overall position often involves both quantitative and qualitative assessments.

i.
Regulation 1 *most closely* promotes:
- (selected) integrity of the financial markets.
- transparency.
- competitive behavior.

Rationale
This Answer is Correct
Regulations that promote fair disclosure seek to ensure the overall integrity of the market by mandating transparency of information flow.

Rationale
This Answer is Correct
Regulations that promote fair disclosure seek to ensure the overall integrity of the market by mandating transparency of information flow.

Rationale
This Answer is Correct
Regulations that promote fair disclosure seek to ensure the overall integrity of the market by mandating transparency of information flow.

ii.
What would be prevented by the adherence to Regulation 2?
- Anticompetitive behavior.
- Systemic risk.
- (selected) Informational asymmetry.

Rationale

This Answer is Incorrect

Information asymmetries allow some market participants to have greater information than others, creating an inherent advantage.

Rationale

This Answer is Incorrect

Information asymmetries allow some market participants to have greater information than others, creating an inherent advantage.

Rationale

This Answer is Incorrect

Information asymmetries allow some market participants to have greater information than others, creating an inherent advantage.

iii.

Rating agencies fill what regulatory role?

- Oversight.
- Self-regulating organization.
- Independent regulator.

Rationale

This Answer is Incorrect

Rating agencies are nationally recognized entities that provide a service and promote regulations related to financial behaviors to the extent that financial behaviors and thresholds provide an incentive to a company to meet targets set by a rating agency.

Rationale

This Answer is Incorrect

Rating agencies are nationally recognized entities that provide a service and promote regulations related to financial behaviors to the extent that financial behaviors and thresholds provide an incentive to a company to meet targets set by a rating agency.

Rationale

This Answer is Incorrect

Rating agencies are nationally recognized entities that provide a service and promote regulations related to financial behaviors to the extent that financial behaviors and thresholds provide an incentive to a company to meet targets set by a rating agency.

Question 21
L2EC-PQ1410-1506
LOS: LOS-6760
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
All of the following are common regulatory tools and measures, except:

- subsidies.
- private financing of public projects.
- establishing rights and responsibilities.

Rationale

This Answer is Correct

Common regulatory tools and measures include the use of price mechanisms such as taxes and subsidies, regulatory mandates and restrictions on behaviors, including establishing rights and responsibilities, provision of public goods, and public financing of private projects.

Question 22
L2R15TB-AC007-1512
LOS: LOS-6790
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: medium
In assessing the financial impact of governmental intervention in a market failure, the *best* evaluation tool is:

- ○ regulatory capture.
- ○ regulatory burden.
- ● net regulatory burden.

Rationale
✗ regulatory capture.
Net regulatory burden is the private costs of regulations less the private benefits of the regulation; it considers both benefits and costs where the regulatory burden only assesses the private costs of regulation.

Rationale
✗ regulatory burden.
Net regulatory burden is the private costs of regulations less the private benefits of the regulation; it considers both benefits and costs where the regulatory burden only assesses the private costs of regulation.

Rationale
✓ net regulatory burden.
Net regulatory burden is the private costs of regulations less the private benefits of the regulation; it considers both benefits and costs where the regulatory burden only assesses the private costs of regulation.

Question 23
L2EC-PQ1403-1506
LOS: LOS-6720
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
A self-regulatory organization is not itself a regulator unless it is given recognition and authority, including enforcement power, from:

- ○ their members.
- ◉ a government body.
- ○ a court of law.

Rationale

This Answer is Correct

Self-regulating organizations are not regulators unless they are given recognition and authority, including enforcement power, by a government body or agency.

Question 24
L2EC-PQ1419-1506
LOS: LOS-6800
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
An issue with the significant bailouts of financial institutions made by governments during the global financial crisis, which began in 2008, is that participants in financial markets may subsequently exhibit:

- (selected) Moral hazard.
- Adverse selection.
- Too little appetite for risk taking.

Rationale

This Answer is Correct

Government bailouts of financial institutions may lead the bailed-out institutions to feel they will not ultimately have to face the consequences of the risks they take. This is a form of moral hazard. It is likely to cause financial institutions to take too much risk, not too little. Moral hazard is separate to adverse selection, which is the issue of unfair advantage due to informational asymmetry.

Question 25
L2EC-PQ1417-1506
LOS: LOS-6780
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
Which of the following is *most likely* to be considered anticompetitive behavior by regulators?

- (selected) Collusion on prices
- Aggressive price cutting to gain market share
- Divesture of assets to break a company up into several businesses

Rationale

This Answer is Correct

Collusion on prices is often regarded as anticompetitive and against government regulations. Price cutting is a form of competition, and divesture of assets is often a solution to anticompetitive behavior enforced on firms by regulators.

Question 26
L2EC-PQ1415-1506
LOS: LOS-6770
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
The majority of securities regulations focus on protection of:

- ( ) Institutions
- (•) Small investors
- ( ) Investors in hedge funds, private equity, and venture capital funds

Rationale

This Answer is Correct

Securities regulations deem institutions and investors in hedge funds, private equity and venture capital funds to be either large enough or sophisticated enough such that they do not need a large amount of regulatory protection.

Question 27
L2EC-PQ1414-1506
LOS: LOS-6770
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
Which of the following types of regulation is *most likely* to deal primarily with promoting financial stability?

- ○ Regulation of commerce
- ● Prudential supervision
- ○ Securities markets regulation

Rationale

This Answer is Correct

Prudential supervision is regulation and monitoring of the safety and soundness of financial institutions to promote financial stability. Regulation of commerce primarily deals with privacy, protection of property, and antitrust issues. Securities markets regulation primarily focuses on protection of the retail investor in financial markets.

Question 28
L2EC-PQ1405-1506
LOS: LOS-6730
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
Which of the following bodies is an example of a self-regulating organization?

- Government agency
- Credit rating agency
- Accounting standard-setting bodies

Rationale

This Answer is Correct

A government agency is not a self-regulating organization since self-regulating organizations should be independent of the government. Whilst a credit rating agency may be referenced by regulations, it is not itself a regulator.

Question 29
L2EC-PQ1406-1506
LOS: LOS-6720
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: hard
Which of the following types of regulation focuses on the rights and the responsibilities of entities and relationships amongst those entities?

- (selected) Substantive law
- Procedural law
- Self-regulation

Rationale

This Answer is Correct

Substantive law focuses on the rights and responsibilities of entities and relationships amongst entities. Procedural law focuses on the protection and enforcement of substantive laws. Self regulation is a form of regulation where members of an industry abide by the rules of a self-regulatory organization.

Question 30
L2EC-ITEMSET-PQ1401-1411
LOS: LOS-6730
LOS: LOS-6740
LOS: LOS-6750
LOS: LOS-6770
LOS: LOS-6790
LOS: LOS-6800
Lesson Reference: Lesson 1: Economics of Regulation
Difficulty: medium

Use the following information to answer the next six questions:

John Metheny, CFA, is a junior employee at a large sell side wall street firm, New House Securities Group, Inc. He is still undergoing his graduate training and is spending several months at a time working in different divisions of the bank before eventually being placed permanently in a fixed role.

Having recently completed a spell in the fixed income execution and research division of the firm, Metheny is moved to the equity research department. On his first morning at the department, there is an announcement of a record breaking penalty of several billion dollars being levied on one of the biggest banks in Europe for knowingly breaching US regulations over several years.

This latest settlement is the most recent in a string of regulatory fines and disciplinary actions that regulators have aimed against financial institutions over the past few years, and the research department is in the process of writing a comprehensive review of the different types of regulation and its impact on economic activity.

Metheny is asked to investigate the regulatory framework employed by Redland, an emerging market with a fast growing economy in recent history.

Metheny makes the following notes in his fact finding:

Note 1:

Regulation in Redland of the finance industry is partly dealt with through three entities:

- The Treasury, a ministry of the government
- The FCSA, an independent regulatory body consisting of employees
- The SFA, a private organization that sets rules and regulations for its members

Note 2:

There has been a significant push in the regulatory structure to introduce legislation dealing with detecting and punishing the act of dealing or disclosing inside information. The SFA appears keen to demonstrate that it is an effective regulator and has led the way in prosecuting some high-profile cases in recent months.

Note 3:

The three regulatory institutions of Redland have responded to a recent crisis of solvency and confidence in the local banking sector that was brought on by a global financial crisis by establishing a body called the Redland Systemic Risk Board (RSRB), which has implemented a series of strict capital requirements stress tests on financial institutions.

Note 4:

The government of Redland's approach to cost-benefit analysis of proposed new regulation is to rigorously test the regulations prior to implementation where it is practically possible and run pilot schemes in order to prospectively assess its impact. The government has stated preference for this policy rather than pursue after-the-fact retrospective analysis that will serve no benefit since the regulation will have already been introduced.

Metheny also reviews the regulation in Redland in other areas of the economy outside that of the financial sector. He notes that the government of Redland responds very aggressively to the threat of international competition to local domestic markets, often introducing taxes, tariffs, and import quotas on imported goods to make them less able to compete with domestic producers.

i.
Which of the entities referred to in Note 1 is *most likely* to be at risk of regulatory capture?

- [ ] The Treasury
- [ ] The FCSA
- [x] The SFA

Rationale

This Answer is Correct

Regulatory Capture occurs when regulation arises to protect the interests of the regulated. This is most likely to be the case when the regulated entities have the most influence over the policy of the regulator. The SFA, most likely being a self-regulatory body from its description, is most likely to be influenced by its members.

ii.
The unethical behavior described in Note 2 is *most likely* an example of:

- [x] Adverse selection
- [ ] Moral hazard
- [ ] Negative externalities

Rationale

This Answer is Correct

Adverse selection occurs when there is private information in the hands of some, but not all market participants, which affects the consumption of goods and services.

iii.
The formation of the RSRB described in Note 3 is *most likely* to cause regulatory arbitrage by financial firms in Redland to:

- [ ] Increase
- [ ] Decrease
- [x] Increase or decrease depending on the actions of the regulatory regimes other jurisdictions

Rationale

This Answer is Correct

Regulatory arbitrage occurs when entities identify and use some aspect of regulation that allows them to exploit differences in economic substance or regulatory interpretation between jurisdictions to the entities' benefit.

iv.
The approach of the government of Redland to assessing the overall costs and benefits of proposed regulation is *most likely*:

- [ ] Consistent with good cost-benefit analysis.
- [x] Inconsistent with good cost-benefit analysis since a post-implementation review will be more efficient at identifying impact and help, enhance accountability.
- [ ] Inconsistent with good cost-benefit analysis since a regulator can never really assess the impact of new regulation since what would have happened had the regulation never been introduced is not observable.

Rationale

This Answer is Correct

Regulatory costs and benefits are especially difficult to assess on a prospective basis compared with a retrospective basis. An after-the-fact analysis allows a comparison of the item(s) of interest before and after the regulation occurs. This comparison allows for a more informed assessment of a regulation because the actual costs and benefits may be identifiable. Greater focus on the economic impact of prior decisions would help enhance accountability.

v.

An aggressive response to international competition such as that employed by the government of Redland is *most likely*:

- [ ] Always beneficial for the domestic society.
- [ ] Consistent with the economic principle of comparative advantage.
- [x] Introducing excess costs to broader society.

Rationale

This Answer is Correct

Comparative advantage suggests that all countries should allocate their efforts to those goods or services for which development efforts are most productive at the margin. In some cases, protecting or encouraging domestic production through government intervention can impose excess costs on the broader society due to society not benefitting from the cheaper import under comparative advantage.

vi.

Higher capital standards introduced by stress tests like those described in Note 3 are designed to:

- [ ] Force institutions to hold a buffer against losses.
- [x] Ensure that investors in the financial institutions are bearing the costs of the risks of the financial institution.
- [ ] Ensure financial institutions do not need to use the central bank discount window facility.

Rationale

This Answer is Correct

High capital standards are an attempt to ensure that investors in the financial institutions bear the costs of the risks of the financial institution. They are not simply a requirement that a company set aside amounts of idle capital as a buffer against losses, or designed in order to stop banks from using the central bank facilities.