Markets for Financial Innovation

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Very preliminary. Do not circulate.

Abstract

Regulators have pushed for centralized trading as a way to increase transparency following the recent financial crisis. However, the nature of the security being traded may change when the market structure in which it trades is forced to change. In this paper, we develop a model to explore interactions between market formation and the design of new financial securities. Our results rationalize why debt contracts are frequently traded in over-the-counter markets whereas equity is typically traded on exchanges. We also find that regulations promoting universally larger markets can reduce investor welfare by reducing the production of securities with less variable payoffs.

JEL Classifications: G14, G21, D82, D43

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