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Abstract

Regulators, much like r ambiguous to regulatory categories but not to market actors present a problem for regulators and an opportunity for innovative firms. Using a wide range of primary and secondary, qualitative and quantitative sources, we trace the history of one class of innovative financial derivatives—interest rate and foreign exchange swaps—to show how these instruments undermined the separation of commercial and investment banking established by the Glass–Steagall Act of 1933 even as overt political action failed to do so. Swaps did not fit neatly into existing product categories—futures, securities, loans—and thus evaded regulatory scrutiny for many years. The market success of swaps put commercial and investment banks into direct competition and, in so doing, undermined Glass–Steagall. Drawing on this case, we theorize that ambiguous innovations may disrupt the regulatory status quo and shift the political burden onto parties that want to maintain existing regulations. Our findings also suggest that category-spanning innovations may be more valuable to market participants if regulators find them difficult to interpret.

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