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Security design with interim public information

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Security Design with Interim Public Information*

André Stenzel†

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We consider a security design problem where public information about the security's underlying cash-flow arrives between trading periods. The optimal security minimizes less-than-full realization of gains from trade due to limited cash in the market, which may depend on the interim information. We show that the optimal security can be expressed as a convex combination of securities solving minimization problems for which the solutions share many debt-like features but exhibit endogenous tranching. We provide conditions for the non-optimality of standard debt contracts and show that implementation of the class of optimal securities can be achieved by mezzanine tranche retention, providing a public information rationale for departure from the pecking order.

JEL Classification: D84, D86, E51, G14

Keywords: Security Design, Public Information Arrival, Tranching, Pecking Order

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