

We examine the impact of financial regulation and innovation on bubbles and crashes due to limited arbitrage by modeling timing games among strategic arbitrageurs whose rationality is not commonly known. An unproductive company raises funds by issuing shares, and for purchasing shares, arbitrageurs borrow money from positive feedback traders. The key concept is awareness heterogeneity: positive feedback traders are unaware of euphoria, but arbitrageurs are aware of it. We show the impact of high leverage ratio depends on whether naked CDS is available, and the impact of naked CDS depends on growth balance between positive feedback traders' capital and loan.