Equity Short Sales and Options: 
Complements or Substitutes?

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Abstract

This paper studies whether equity short sales and options are complements or substitutes and finds that they are substitutes when the underlying market faces trading constraints. This substitutability is associated with far-reaching implications for stock price volatility and liquidity. Stocks that are subject to such constraints and have exchange-traded options are more volatile and less liquid than both constrained stocks without options and unconstrained stocks. Traders predominantly use at-the-money options to substitute equity short sales.

Key Words: Trading restrictions, Short selling, Derivatives, Regulation

JEL classification: G10, G14, G18

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