Options, Short Sales, and Market Completeness

by

Stephen Figlewski *
Gwendolyn P. Webb **

Revised April 1991

* Professor of Finance
Leonard N. Stern School of Business
New York University

** Assistant Professor of Finance
Baruch College
City University of New York

We would like to thank the Interactive Data Corporation for providing data used in this study, and Baruch College for research support. We are grateful for helpful comments on earlier versions of the paper from Robert Whaley, participants in seminars at Baruch College and Boston College, and an anonymous referee. Thanks also to Jeffrey Heisler for excellent research assistance.
Options, Short Sales, and Market Completeness

by

Stephen Figlewski
Gwendolyn P. Webb

ABSTRACT

This paper presents empirical evidence that trading in options contributes to both the transactional and informational efficiency of the stock market by reducing the effect of constraints on short sales.

We first show that optionable stocks exhibit a significantly higher level of short interest than stocks without options. This is interpreted as evidence that options trading creates a channel by which investors who face constraints on selling a stock short can effectively do so through the options market. We also find significant price effects on options that are related to the level of short interest in the underlying stock. Both of these results point to an increase in transactional efficiency in the market associated with options trading.

We then present evidence that options also increase information efficiency in the market. Earlier work, that is replicated and extended here, has suggested that constraints on short sales have an informational effect on stock prices because negative information tends to be underweighted in the market price. We find that the existence of options appears to reduce that effect.