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A Study of Market-Wide Short-Selling Restrictions

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Abstract

This paper contributes empirical evidence to the on-going debate on short sales. Our examination of how market-wide short-sale restrictions affect aggregate market returns focuses on two main questions: What is the effect of short-sale restrictions on skewness, volatility, the probability of market crashes, and liquidity? What is the effect on the market expected return or cost of capital? We report new data on the history of short-selling and put option trading regulations and practices from 111 countries, and create a short-selling feasibility indicator for the analysis of stock market indices around the world. We find that when short-selling is possible, aggregate stock returns are less volatile and there is greater liquidity. When countries start to permit short-selling, aggregate stock price increases, implying lower a cost of capital. There is no evidence that short-sale restrictions affect either the level of skewness of returns or the probability of a market crash. Collectively, our empirical evidence suggests that allowing short-selling enhances market quality.

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