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ABSTRACT

The illiquidity risk premium hypothesis implies the existence of a positive relation between illiquidity in the option market and option returns. Based on numerous studies within the extant literature examining the roles of informed traders in the option markets, we explore how information asymmetry and short sales affect the illiquidity risk premium hypothesis. We find that the illiquidity risk premium is higher for both call and put options of those firms with higher information asymmetry, which is particularly driven by small firms. We also find that it is higher for put (call) options of those stocks with lower (higher) short-sale supply (demand).

Keywords: Information asymmetry; Short sales; Short-sale constraints; Informed traders; Option illiquidity premium.

JEL Classification: G14.

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