

THREE ESSAYS ON EXECUTIVE COMPENSATION

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The purpose of this dissertation is to analyze, theoretically and empirically, the effect on the adoption of executive stock option plans on firm claimants and on the risk-taking behavior of executives.

This dissertation is organized into three essays. The first essay provides an overview of the theoretical and empirical academic research on executive compensation. Particular emphasis is placed on the role of executive stock option plans and their effects on managerial incentives.

The second essay provides an empirical analysis of the effect on firm claimants of the adoption of executive stock option plans. Four hypotheses are examined: 1) they improve managerial incentives, 2) they cause managers to take on more risk, thus redistributing wealth from bondholders to stockholders, 3) they are a means whereby managers can capture the value of good news, and 4) they are the most efficient means to minimize taxes when compensating executives. The evidence presented in this essay is consistent with the wealth transfer hypothesis. We find that stock cumulative abnormal returns are positively related to the size of the stock option plan, while bond cumulative abnormal returns are negatively related to the size of the plan. In addition, the evidence supports the contention that the existence of convertible debt in a firm's capital structure is successful in mitigating wealth transfers.

The final essay investigates the effect of stock option plans on the risk-taking behavior of executives as measured by changes in firm variance. This investigation is performed by analyzing implied variances from traded stock options. The results indicate that the adoption of

executive stock option plans has a significant effect on the risk-taking activities of executives. The result of a non-parametric test provides evidence consistent with the hypothesis that stock variance increases following executive stock option plan adoption. In a second test, percentage change in firm variance is shown to be significantly positively related to plan size. These findings, along with the results from the second essay, provide evidence of a wealth transfer.