

## “Optimal Contracts in Executive Compensation”

### Abstract:

In the first half of the talk we study when option grants are preferred to stock compensation, in particular in order to screen low-ability executives. In a dynamic setting, we consider the problem of a risk-neutral firm that tries to hire a risk-averse executive whose actions can affect the expected return and volatility of the stock price. Even if the optimal compensation for all types of executives is stock under complete information, it might be optimal to offer options under incomplete information, although a pooling equilibrium in which the optimal contract is stock is also possible. We show that the likelihood of using options increases with the dispersion of types and the size of the firm, and decreases with the availability of growth opportunities for the firm. In the second half of the talk we present consequences of the general continuous-time principal-agent theory on executive compensation.

In particular, we specify conditions under which nonlinear (option-like) contracts vs. linear stock + cash) contracts are optimal, and conditions under which it is better for the firm to compensate with European rather than American type options.