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HEDGE MARKETS FOR EXECUTIVES AND CORPORATE AGENCY

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Abstract

This paper analyzes the implications of executive hedge markets for firm value maximization in an optimal contracting framework. The main results are as follows: without any hedging ability, the manager underinvests in risk at the firm level to diversify his own compensation risk. If the manager can trade a security correlated with firm specific risk, the underinvestment in risk is reduced, optimal managerial share ownership and equilibrium effort increase. If the manager can hedge by simulating the sale of his shares, however, he can completely undo any incentive scheme. The model predicts that a higher degree of financial market development implies higher managerial share ownership and more efficient risk taking at the firm level.

Keywords: managerial hedge markets, inefficient risk reduction, effort provision, optimal managerial share ownership, security innovation.

JEL Classification: G30, G32.

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