Executive Stock Options:
Early Exercise Provisions and Risk-taking Incentives

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Abstract

Traditional Executive Stock Option plans typically allow fixed numbers of options to vest over a period of several years, independent of stock price performance. Such options may climb deep in-the-money long before the manager is permitted to exercise them, potentially making the manager more risk averse in project selection. When firms face risky-but-profitable growth opportunities, we show that by making the proportion of options that vest a gradually increasing function of the stock price achieved, the firm can ensure that appropriate numbers of options are retained when still providing risk-taking incentives, but exercised once they have lost their convexity. Our proposed 'progressive performance vesting' can allow the firm more efficiently to rebalance risk-taking incentives for the manager.

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