Accepted Manuscript

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PII: S0929-1199(16)30352-2
DOI: doi:10.1016/j.jcorpfin.2016.12.003
Reference: CORFIN 1130

To appear in: *Journal of Corporate Finance*

Received date: 8 March 2016
Revised date: 9 December 2016
Accepted date: 10 December 2016

Option Incentives, Leverage, and Risk-Taking

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Abstract

While there is extensive research on how option incentives in executive compensation relate to risk-taking by managers, the impact of capital structure on this relationship has received little empirical attention. Extant work suggests that heightened managerial career concerns arising from financial risk and monitoring by debt holders will result in leverage dampening the relationship between managerial risk-taking and equity-linked incentives. We empirically evaluate this contention and find that firm leverage is associated with a significant weakening of the positive relationship between option incentives in flow compensation and managerial risk-taking. This result holds after accounting for the endogeneity of the firm leverage and incentive compensation decisions, and is robust across alternative measures of managerial risk-taking and to using the firm's credit ratings instead of leverage. The attenuating effect of firm leverage arises from both the long-term and short-term components of debt and is significantly stronger during the financial crisis of 2007-2009. Overall, the evidence highlights the influence of capital structure on the relationship between option incentives and managerial risk-taking.

Keywords: *Option incentives, risk-taking, leverage, credit ratings, debt holder monitoring, career concerns*

JEL Classification Codes: G30, G32

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