

# Managerial Incentives, Financial Innovation, and Risk-Management Policy\*

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## Abstract

This paper examines risk management issues from the perspective of a firm run by an effort and risk-averse manager. We show that when shareholders observe manager's risk choice, but not the effort, the optimal compensation contract will direct managers to expose the firm to less risk than they would in the full information environment (e.g., execute costly hedges). Innovations in risk management technology, e.g., the introduction of a derivative market, always improves the efficiency of the manager's compensation contract when the risk choice can be observed, and this efficiency gain continues to hold under some circumstances when the manager's risk choice cannot be observed by shareholders. In other cases, however, due to the incentive problems associated with the hedging choice, financial innovation can lower welfare.

**Keywords:** Agency, Risk management, Hedging

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# 1 Introduction

U.S. corporations spend substantial resources on assessing and managing their exposures to various sources of risk not only for their own survival but also for the stability of the entire financial system. The global financial crisis (GFC) and the subsequent Great Recession taught us an important lesson that each corporation's imprudent risk choices lead to its own collapse, while imposing tremendous negative externalities on the aggregate economy. A new set of regulations for properly managing individual firms' risk exposures and minimizing the contagion of risks were introduced afterwards, including Basel I, II and III accords, and interests in benefits of risk management and necessary regulations soared up. Indeed, risk management's various implications have been one of the most important topics in academic economics and finance and documented in a number of academic and professional articles.<sup>1</sup>

However, in most cases until recently, those articles have ignored the fact that risk management choices are made not by the *value-maximizing firms (or shareholders)*, but by *self-interested managers*. In contrast, popular press and policy institutions have been quite concerned with issues relating to the incentives of managers to 'properly' manage companies' risk, focusing on a number of highly visible cases where it appears, at least ex post, that managers were using derivatives to speculate rather than hedge,<sup>2</sup> Ben Bernanke, a former chair of the Federal Reserve, for instance stated following the global financial crisis (GFC) that "compensation practices at some banking organizations have led to misaligned incentives and excessive risk-taking, contributing to bank losses and financial instability."<sup>3</sup> This feature extends even beyond financial institutions. In a study of gold mining industry, for instance, Tufano (1996) found that the managerial incentives were the most important determinant of corporate derivatives choices.

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<sup>1</sup>For classical literatures, see Smith and Stulz (1985), DeMarzo and Duffie (1991), DeMarzo and Duffie (1995), and Froot et al. (1993) among others. Geczy et al. (1997) examined implications of these theories empirically. Draghi et al. (2003), in particular, emphasized the role of unintended or unanticipated accumulation of large risks as the breeding conditions for financial crises. One interesting point they make is that implicit guarantees that governments extend to banks and other financial institutions might lead to the over-accumulation of risks in the system, which aligns with our moral hazard point of view. More recently, Farhi and Tirole (2012) studied banks' collective moral hazard issues in the environment where government's bail-out policies are possible and anticipated.

<sup>2</sup>For example, in 1994 and 1995, there were two firms, Barings and Metallgesellschaft, that either went bankrupt or nearly went bankrupt as a result of their speculative transactions in financial derivatives. And the global financial crisis (GFC) illustrated how big corporations (such as AIG, Lehman Brothers, etc) had been speculating imprudently using derivatives while being ignorant of their own risk exposures.

<sup>3</sup>Fed press release (2009): <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20091022a.htm>.

This paper examines firms' risk management choices within an agency framework, where managers (agents) control not only the effort they expend, which affects the firm's average cash flow, but also the riskiness of the cash flow by choosing real investment projects as well as their positions in derivatives.<sup>4</sup> We assume that shareholders (principals) are unable to directly assess the extent to which the managers are acting in their own interests rather than the shareholders' (e.g., managers may be effort averse or equivalently consume unproductive perquisites).

Our analysis indicates that financial innovations (e.g., the introduction of a new derivative contract) that provide managers with greater flexibility to control risk can mitigate some agency problems and thereby improve firm values. However, this added flexibility might lead to other agency problems if the managers' use of these derivatives cannot be effectively controlled. When this is the case, financial innovation can reduce welfare.

To understand how manager's access to derivative markets affects costs arising from the agency relation, we divide firms' risks into two different components: *hedgeable risks* and *non-hedgeable risks*. Basically, a company's hedgeable risks are related to some market observables such as interest rates, commodity prices, and exchanges rates on which derivative contracts can be written, whereas non-hedgeable risks are risks that cannot be traded in the derivatives market. The total amount of a firm's hedgeable risk depends not only on those market observables but also on the firm's endogenous exposure to those observables (e.g., how cash flows are influenced by changes in oil prices). The firm's hedgeable risk exposure can be amended by its manager's derivative transactions, while its non-hedgeable risks are mainly determined by the manager's real project choices.

In the benchmark case where there is no derivative market, the manager affects the firm's risks only through real investment choices. If the firm's risk exposure to hedgeable risks is observed by both the manager and the shareholders in the benchmark case, the typical dual-agency framework à la [Hirshleifer and Suh \(1992\)](#) applies. Specifically, the manager generally does not choose a real investment project (non-hedgeable risk) that would be preferred by shareholders. Therefore, the manager's optimal compensation contract must be designed not only to incentivize him to take the

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<sup>4</sup>Most papers about the principal-agent problem are concerned with the agent's effort choices but not with activities that affect the project's risk exposures, e.g., [Harris and Raviv \(1979\)](#), [Holmström \(1979\)](#), [Shavell \(1979\)](#), and [Grossman and Hart \(1983\)](#). Other papers consider only the agent's risky project choice problem, e.g., [Ross \(1974\)](#), [Lambert \(1986\)](#), and [Hirshleifer and Thakor \(1992\)](#). Important exceptions are [Hirshleifer and Suh \(1992\)](#), [Sung \(1995\)](#), [Palomino and Prat \(2003\)](#), [Ross \(2004\)](#), [DeMarzo et al. \(2013\)](#), [Hébert \(2018\)](#) among others, which simultaneously examine the agent's risk and effort choices in either a single-period framework or a continuous time agency framework.

right effort level but also to induce him to choose the right project from the principal's perspective. We show that the optimal compensation contract either rewards or penalizes the output variances depending on whether the manager must be rewarded or deterred from taking riskier projects.

In reality, communication between shareholders and the manager is costly when the firm's risk exposure is observed only by the manager and not by shareholders.<sup>5</sup> Then, what the uninformed shareholders can do at best is to design a wage contract without using any information on the firm's risk exposure, directly or indirectly, and let the informed manager decide both effort and project choice based on the observed risk exposure of the firm. Due to this asymmetric information about the firm's risk exposure, there would inevitably be some welfare loss compared with the benchmark case.

Our analysis indicates that the introduction of derivative markets always improves welfare when the optimal contract in the absence of a derivative market discourages risk taking. Intuitively, this makes sense since the manager in this case will voluntarily choose to hedge completely given the contract that would be optimal in the absence of the hedging opportunity. In this case, there is no welfare cost that arises from the hedgeable risk exposure being unobservable to shareholders, as the manager eliminates it through hedging activities anyway.

However, there will be costs associated with the introduction of derivative markets when the optimal compensation contract in the absence of a derivative market rewards the agent for taking risk. In this case, the incentive contract needs to be altered to induce the manager to use financial derivatives to hedge, not speculate. As we show, in this case, to incentivize the manager to hedge, the compensation contract must penalize a (both positive and negative) sample covariance (realized covariance) between the market observable and the output (e.g., covariance between oil prices and profits of the firm)<sup>6</sup>. However, revising the compensation contract in this way can be costly because it imposes additional risk on the risk-averse manager. Indeed, in some cases, the costs associated with inducing optimal hedging exceeds the informational benefit of hedging, which implies that the shareholders should *optimally* restrict the agent's access to the derivative market.

Since the motivation for hedging suggested by our model requires that the firm's risk exposure

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<sup>5</sup>For example, this point was discussed by Laffont and Martimort (1997).

<sup>6</sup>Under the compensation contract that penalizes a sample covariance between the hedgeable risks and output, the manager would be tempted to reduce a covariance through hedging transactions in the derivative market and reducing the firm's exposure to the market observables.

to be unobservable by the principal, it makes sense to ask if the agent can be induced to truthfully reveal this information. As we show, when costless communication between principal and agent is possible, a contract that induces truthful revelation can be designed, without a derivative market, that is at least as good as the contract that requires hedging in the derivatives market. This indicates that if the agency relation is interpreted as a relation between the central headquarters of a firm (the principal) and a division head (the agent), the optimal compensation contract will not necessarily require the division head to hedge since it may be possible to do just as well with a compensation contract that is contingent on information communicated from the agent to the principal. However, if we view the relation between the CEO of a firm (the agent) and a diffuse group of shareholders (the principal), then the assumption of free communication is probably untenable and the optimal contract will probably allow the CEO to engage in derivative transactions.

There has been a growing literature that tackle the issue of agency relationships and risk choices. On theory side, [Hirshleifer and Suh \(1992\)](#), [Sung \(1995\)](#), [Palomino and Prat \(2003\)](#), [DeMarzo et al. \(2013\)](#) among others analyzed the case where the agent chooses the parametric risk of the output distribution. [Hirshleifer and Suh \(1992\)](#) especially analyzed the model in which a risk-averse agent chooses not only his effort level but also the firm's real project which is relevant for the risk level. They showed that principal and agent will not generally agree on the firm's risk level, and agent's compensation contract should be revised in a way that it is more concave (convex) compared with the contract that would optimally be designed without the incentive problem associated with his risk choice, when the principal prefers a lower (higher) risk level than the agent. However, they did not derive the optimal compensation contract in a general framework, and furthermore, did not analyze the effects of a derivative market. [DeMarzo et al. \(2013\)](#) concluded that principal has to pay a large bonus if a firm survives, in order to disincentivize an agent from putting the firm at 'disaster' risk. It's in line with our Proposition 5 that the principal punishes covariance between the output and the hedgeable risk to induce the agent to fully hedge in the derivative market. Among papers that deal with nonparametric risk choices: [Makarov and Plantin \(2015\)](#), [Hébert \(2018\)](#), [Barron et al. \(2020\)](#), [Barron et al. \(2020\)](#) considered the case where a 'mean-preserving spread (MPS)' risk can be added by the agent without cost and figured out that the agent's indirect utility must be concave at optimum to discourage the agent's additional risk-taking. Our paper contributes to the literature by analyzing the effect of a derivative market on the efficiency of agency relations in

lights with how shareholders should alter the manager's compensation contract to induce hedging. The empirical literature, e.g., [Guay \(1999\)](#), [Rajgopal and Shevlin \(2002\)](#), [Coles et al. \(2006\)](#) among others, found that the higher a vega (i.e., sensitivity of CEO's wealth to the stock market volatility) is, the riskier stock returns and firms' project choices become, with more focused investments and higher leverage ratios. It confirms our view that the convexity of manager's compensation contract is a major driving force behind his choice over risk.<sup>7</sup>

The rest of the paper is organized as follows. In Section 2, we formulate the basic model. In Section 3, as a benchmark case, we consider the case in which there is no derivative market. Thus, the manager's risk choices are carried out only through his real investment choices. In Section 4, we consider the case in which there is a derivative market. In Section 5, we also consider the case in which there is free communication between the principal and the agent. Concluding remarks are provided in Section 6, and the proofs of the Lemmas and Propositions as well as omitted derivations are all given in the Appendix.

## 2 The Basic Model

We consider a two-person single-period agency model in which a risk-averse agent works for a risk-neutral principal. The principal can be thought of as firm's shareholders, and the agent can be regarded as firm's top manager or CEO. Alternatively, we can think of the principal as CEO and the agent as a head of one of firm's subordinate divisions. Hereafter, we use the terms 'agent' and 'manager' interchangeably.

After his wage contract is finalized, agent takes three kinds of actions,  $a_1 \in [0, \infty)$ ,  $a_2 \in [\underline{a}_2, \bar{a}_2]$ , and  $a_3 \in (-\infty, +\infty)$ . Agent's first action is a productive effort which increases an expected output, that is, a high effort generates an output level that first-order stochastically dominates the output level generated by a low effort. The agent's second action is his project choice. Projects have different risk levels with more risky projects having higher expected outputs. The third action is his choice in the derivatives market. We assume that the set of projects available to the agent is

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<sup>7</sup>Another closely related paper to ours is [DeMarzo and Duffie \(1995\)](#), which studies the ways that risk management reduces uncertainty about the manager's unobservable actions. However, in contrast to our analysis, in [DeMarzo and Duffie \(1995\)](#), differences in actions are due to differences in ability rather than differences in effort.

bounded, i.e.,  $a_2 \in [\underline{a}_2, \bar{a}_2]$ , while the agent can choose any position in the derivatives market, i.e.,  $a_3 \in (-\infty, +\infty)$ .

After the agent chooses  $a_1$ ,  $a_2$ , and  $a_3$ , the firm's output,  $x$ , is realized and publicly observable without cost. Thus, an output  $x$  can be used in the manager's wage contract that is denoted by  $w$ . The output is determined not only by the agent's choice of  $(a_1, a_2, a_3)$  but also by the state of nature,  $(\eta, \theta)$ . For simplicity, we assume that the output function exhibits the following additively separable form:

$$x = \phi(a_1, a_2) + (R - a_3)\eta + a_2\theta. \quad (1)$$

An expected output,  $\phi(a_1, a_2)$ , is a function of both  $a_1$  and  $a_2$ , whereas the agent's derivatives choice,  $a_3$ , does not directly affect it. The firm's risk is decomposed into two components,  $\eta$  and  $\theta$ , where  $\eta \sim N(0, 1)$  represents one unit of the firm's hedgeable risks and  $\theta \sim N(0, 1)$  represents one unit of the firm's non-hedgeable risks. As denoted by equation (1), the firm's total non-hedgeable risks are determined by the manager's project choice,  $a_2$ , whereas the firm's hedgeable risks are determined by market variables such as commodity prices, interest rates, and exchange rates which become publicly observable after the agent chooses  $a_1$ ,  $a_2$ , and  $a_3$ .<sup>8</sup> Accordingly, we assume  $\eta$  is observable at the end of the period and thus can also be used in the manager's wage contract if necessary. In the above equation,  $R \sim N(R_m, \sigma_R^2)$  denotes the firm's innate exposure to the hedgeable risks such as the amount of oil underground for a drilling company. We assume that the manager can observe the true value of  $R$  after the contract is signed but before he chooses  $a_1$ ,  $a_2$ , and  $a_3$ . In contrast, the principal knows only its distribution. We assume neither a management effort ( $a_1$ ) nor a project choice ( $a_2$ ) affects  $R$ , the firm's innate exposure to the hedgeable risks.<sup>9</sup> However, the firm's final risk exposure can be manipulated by the manager's transaction  $a_3$  in the derivative market. If  $a_3 = 0$ , the manager does not trade derivatives. The manager hedges, i.e., reduces risk, as long as  $|R - a_3| < |R|$  and minimizes risk by setting  $a_3 = R$ . On the other hand, if  $|R - a_3| > |R|$ , the manager speculates in the derivative market.

In addition, we make the following assumptions:

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<sup>8</sup>In fact, if the relevant derivative market observable is denoted as  $p$ , then  $\eta = p - \bar{p}$  where  $\bar{p}$  is the expected value of  $p$ .

<sup>9</sup>In general, a firm's risk exposure is very much dependent on the production project undertaken. However, even if we allow the firm's risk exposure to be affected by the manager's project choice ( $a_2$ ), most results in this paper will not change qualitatively.

**Assumption 1** The agent's preferences on wealth and productive effort are additively separable :

$$U(w, a_1, a_2, a_3) = u(w) - v(a_1), \quad u' > 0, u'' < 0,$$

where  $v$ , the agent's disutility of exerting productive effort, has the properties  $v' > 0, v'' > 0, \forall a_1$ .

**Assumption 2**  $\frac{\partial \phi}{\partial a_1}(a_1, a_2) \equiv \phi_1(a_1, a_2) > 0, \frac{\partial^2 \phi}{\partial a_1^2}(a_1, a_2) \equiv \phi_{11}(a_1, a_2) < 0$ .

**Assumption 3**  $\frac{\partial \phi}{\partial a_2}(a_1, a_2) \equiv \phi_2(a_1, a_2) > 0, \phi_{22}(a_1, a_2) < 0, \phi_2(a_1, \underline{a}_2) = \infty$ , and  $\phi_2(a_1, \bar{a}_2) = 0$ .

**Assumption 4**  $0 < \underline{a}_2 < \bar{a}_2 < \infty$ .

Assumption 1 implies that the agent is risk-averse and effort-averse, and the agent's project and derivatives choices have no direct effect on his utility. Assumptions 2 and 3 indicate that  $a_1$  affects the expected output with a usual property of decreasing marginal increase in output, while a higher  $a_2$  raises the expected output in the similar way and also the output variability. Especially, since expected value of output as well as its variability increases in  $a_2$ , there is an assumed trade-off between return and risk.<sup>10</sup> Assumption 4 states that there is neither a completely safe project nor a project with unbounded risk.

### 3 When There Is No Derivative Market

#### 3.1 The Principal Knows the Firm's Exposure to the Hedgeable Risks

In this section, we consider a benchmark case in which the firm has no access to a derivative market, and the principal also knows the true value of the firm's innate risk exposure,  $R$ . We thus specify  $a_3 = 0$  so that the production function in equation (1) reduces to

$$x = \phi(a_1, a_2) + R\eta + a_2\theta. \tag{2}$$

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<sup>10</sup>As noted from equation (1), reducing the firm's non-hedgeable risks requires the firm to sacrifice a part of an expected output. This trade-off guarantees the existence of an optimal project choice  $a_2$  in our agency setting.



Since there is no derivative market, the manager's incentive problem arises only in inducing  $(a_1, a_2)$ . As  $R$  and  $\eta$  are observable and thus contractible,  $y \equiv x - R\eta$  is a sufficient statistic for  $(x, \eta)$  in assessing  $(a_1, a_2)$ . Therefore, the principal uses  $y$  as a contractual variable to induce  $(a_1, a_2)$ , and the above equation can be expressed as

$$y = \phi(a_1, a_2) + a_2\theta. \quad (3)$$

In general, designing a contract to induce agent's project choice  $(a_2)$  as well as the effort choice  $(a_1)$  should be different from designing a contract that only induces the agent's effort choice  $(a_1)$ .<sup>11</sup> Thus, to study how the existence of an additional incentive problem associated with the agent's project choice  $a_2$  affects the agent's wage contract, we first consider a typical standard agency case in which the agent's project choice,  $a_2$ , is observable, or equivalently, the principal selects the project level  $a_2$  by himself and mandates it.

The optimal compensation contract  $w(\cdot)$ , in this case, is found by solving for the contract which maximizes the combined utilities of the principal and agent subject to the restriction that the agent's effort  $a_1$  is chosen to maximize his utility given the contract.<sup>12</sup>

$$\begin{aligned} \max_{a_1, a_2, w(\cdot)} & \phi(a_1, a_2) - \int w(y)f(y|a_1, a_2)dy + \lambda \left( \int u(w(y))f(y|a_1, a_2)dy - v(a_1) \right) \quad \text{s.t.} \\ (i) & a_1 \in \arg \max_{a'_1} \int u(w(y))f(y|a'_1, a_2)dy - v(a'_1), \quad \forall a'_1, \\ (ii) & w(y) \geq k, \quad \forall y, \end{aligned} \quad (4)$$

where  $f(y|a_1, a_2)$  denotes a probability density function of  $y$  given the agent's three actions, and  $\lambda$  denotes the weight placed on the agent's utility in the joint optimization. As shown, the combined utilities of the principal and the agent are maximized subject to the agent's incentive compatibility constraint which specifies that the agent chooses his effort for his own optimization, and his limited liability constraint which specifies that the agent receives at least  $k$ , the subsistence level of utility.<sup>13</sup>

<sup>11</sup>Hirshleifer and Suh (1992) call this issue as a 'dual-agency problem'.

<sup>12</sup>This yields a mathematically equivalent solution to a model where the principal maximizes his utility subject to an optimizing agent receiving his reservation utility level. Our purpose here is to analyze the overall efficiency implication of financial market innovations and thus we choose to fix  $\lambda$ , which usually is an endogenous Lagrange multiplier in the latter case.

<sup>13</sup>The limited liability constraint is introduced to guarantee the existence of optimal solution for  $w(y)$ . This is needed

Subject to some technical assumptions,<sup>14</sup> the above maximization problem reduces to:

$$\begin{aligned} \max_{a_1, a_2, w(\cdot)} & \phi(a_1, a_2) - \int w(y) f(y|a_1, a_2) dy + \lambda \left[ \int u(w(y)) f(y|a_1, a_2) dy - v(a_1) \right] \quad \text{s.t.} \\ (i) & \int u(w(y)) f_1(y|a_1, a_2) dy - v'(a_1) = 0, \\ (ii) & w(y) \geq k, \quad \forall y, \end{aligned} \quad (5)$$

where  $f_1$  denotes the first derivative of  $f$  taken with respect to  $a_1$ .

To find solution  $(a_1^P, a_2^P, w^P(y|a_1^P, a_2^P))$  for the above program, we first derive an optimal contract for an arbitrarily given action combination  $(a_1, a_2)$ . Let  $w^P(y|a_1, a_2)$  be a contract which optimally motivates the agent to take a particular level of  $a_1$  when an arbitrary level of  $a_2$  is chosen by the principal. By solving the Euler equation of the above program after fixing  $(a_1, a_2)$ , we derive that  $w^P(y|a_1, a_2)$  must satisfy

$$\frac{1}{u'(w^P(y|a_1, a_2))} = \lambda + \mu_1(a_1, a_2) \frac{f_1}{f}(y|a_1, a_2), \quad (6)$$

for almost every  $y$  for which equation (6) has a solution  $w^P(y|a_1, a_2) \geq k$ , and otherwise  $w^P(y|a_1, a_2) = k$ . In equation (6),  $\mu_1(a_1, a_2)$  denotes the optimized Lagrange multiplier for the agent's incentive constraint associated with  $a_1$  when the second action is pinned down at  $a_2$ . Since  $f(y|a_1, a_2, a_3 = 0)$  is a normal density function with mean  $\phi(a_1, a_2)$  and variance  $a_2^2$ , equation (6) is reduced to:

$$\frac{1}{u'(w^P(y|a_1, a_2))} = \lambda + \mu_1(a_1, a_2) \frac{[y - \phi(a_1, a_2)]}{a_2^2} \phi_1(a_1, a_2). \quad (7)$$

Before analyzing the optimal contract, we first define given  $(a_1, a_2)$ :

$$SW^P(a_1, a_2) \equiv \phi(a_1, a_2) - C^P(a_1, a_2) - \lambda v(a_1), \quad (8)$$

because we assume that the signal is normally distributed. For details about this 'unpleasantness', see [Mirrlees \(1974\)](#) and [Jewitt et al. \(2008\)](#).

<sup>14</sup>We assume that the first-order approach is valid. [Grossman and Hart \(1983\)](#) and [Rogerson \(1985\)](#) show that MLRP and CDFC are sufficient for the validity of the first-order approach when the signal space is of one dimension. [Jewitt \(1988\)](#) finds less restrictive conditions for the validity of the first-order approach, which are based on the agent's risk preferences as well as the distribution function of the signal. [Sinclair-Desgagné \(1994\)](#) shows that more generalized version of MLRP and CDFC in a multi-dimensional space are sufficient for the validity of the first-order approach when the signal space is of multiple dimensions. For more recent treatments, see [Conlon \(2009\)](#), [Jung and Kim \(2015\)](#) among others.

which denotes the joint benefits when  $w^P(y|a_1, a_2)$  is designed and  $a_2$  is instructed by the principal where

$$C^P(a_1, a_2) \equiv \int [w^P(y|a_1, a_2) - \lambda u(w^P(y|a_1, a_2))] f(y|a_1, a_2) dy \quad (9)$$

represents the efficiency loss of this case compared with the full information case. In other words,  $C(a_1, a_2)$  measures the agency cost arising from inducing the agent to take that particular  $a_1$  when  $a_2$  is chosen by the principal. Before we proceed, we make the following additional assumption.

**Assumption 5**  $\phi_{12}(a_1, a_2) \cdot a_2 < \phi_1(a_1, a_2), \forall (a_1, a_2)$ .

If  $\phi_{12}(a_1, a_2)$  is positive and decreasing in  $a_2$ , and  $\phi_1(a_1, a_2) \simeq 0$ ,  $a_2$  is close to 0, then Assumption 5 holds as we see in Figure 1. As the manager raises a risk level  $a_2$ , an increase in effort  $a_1$  (for example, more intense portfolio management) yields a higher increase in expected output  $\phi(a_1, a_2)$ . Thus it is likely that  $\phi_1(a_1, a_2)$  increases in  $a_2$  and  $\phi_{12}(a_1, a_2) > 0$  holds. This complementarity gets weaker as the project becomes riskier, since corporations can't efficiently allocate their attention over their high risk balance sheets, as the global financial crisis (GFC) showed clearly.

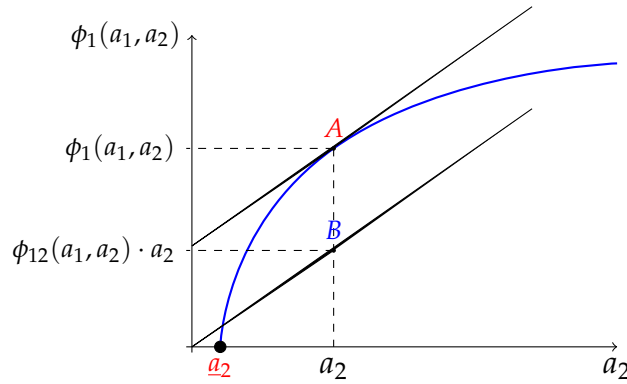


Figure 1: Illustration of the Assumption 5

We start our analysis with the following lemma, which was previously provided in Kim (1995).

**Lemma 1**  $C^P(a_1, a_2^0) < C^P(a_1, a_2^1)$  for any given  $a_1$  if  $a_2^0 < a_2^1$ .

Since principal can dictate the agent's project choice, agency problem arises only in inducing  $a_1$ . Lemma 1 says under the Assumption 5, when the agent's project choice can be instructed by the principal, the agency cost associated with motivating the agent to take any given  $a_1$  will be reduced if the principal chooses a less risky project. A lowered risk improves the efficiency of an agency

relationship by providing a more precise signal  $y$  about the agent's effort,  $a_1$ , which in turn enables the principal to design contract inducing a particular  $a_1$  in a less costly way. If  $\phi_{12}(a_1, a_2)$  is large enough to break Assumption 5, then lower  $a_2$  might lower  $\phi_1(a_1, a_2)$  a lot, which in turn makes harder for the principal to give the proper incentive for the action  $a_1$  and raise the incentive cost  $C^P(a_1, a_2)$ . Assumption 5 guarantees that this incentive drawback is lower than the informational rent from lower  $a_2$ , so principal wants a lower level of non-hedgeable risk  $a_2$ .

Lemma 1 suggests firms should take all zero net present value projects that reduce their risks. However, given the trade-off relation between return and risk, i.e.,  $\phi_2 > 0$ , the exact level of  $a_2$  that the principal prefers will be determined by the loss in expected return as well as the benefit from more precise signals. Let  $a_2^P$  be the project that is most preferred by the principal, and  $a_1^P$  the agent's optimal effort choice for the above program when  $a_2^P$  is chosen by the principal. Then, as we prove in Appendix, from the above optimization we obtain that  $(a_1^P, a_2^P, w^P(\cdot))$  should satisfy

$$\int [y - w^P(y) + \lambda u(w^P(y))] f_2(y|a_1^P, a_2^P) dy + \mu_1(a_1^P, a_2^P) \int u(w^P(y)) f_{12}(y|a_1^P, a_2^P) dy = 0, \quad (10)$$

where  $w^P(\cdot) = w^P(\cdot|a_1^P, a_2^P)$ ,  $f_2$  denotes the first derivative of  $f$  with respect to  $a_2$  and  $f_{12}$  is the second derivative with respect to  $a_1$  and  $a_2$ . We obtain the optimal contract  $w^P(y|a_1^P, a_2^P)$  satisfies,

$$\frac{1}{u'(w^P(y|a_1^P, a_2^P))} = \lambda + \mu_1(a_1^P, a_2^P) \frac{[y - \phi(a_1^P, a_2^P)]}{(a_2^P)^2} \phi_1(a_1^P, a_2^P), \quad (11)$$

for  $y$  satisfying  $w^P(y|a_1^P, a_2^P) \geq k$  and  $w^P(y|a_1^P, a_2^P) = k$  otherwise.

The above result assumes shareholders are fully aware of the projects chosen by the manager. However, it is not realistic, so we also turn our eyes to the manager's incentive to increase or decrease the firm's risk when the project choice is not fully revealed to the shareholders. Specifically, we ask whether the manager will voluntarily choose the project that would be chosen by informed shareholders, i.e.,  $a_2^P$ . If the answer to this question is no, then the moral-hazard problem arises not only in motivating  $a_1$  but also in incentivizing  $a_2$ . As a result, there are costs associated with the project choice being unobservable, and the optimal wage contract must be modified from the contract,  $w^P(y|a_1^P, a_2^P)$ , in equation (11).

To formally analyze this issue, we denote  $a_2^A(a_2^P)$  as a solution for

$$a_2^A(a_2^P) \in \arg \max_{a_2} \int u(w^P(y|a_1^P, a_2^P)) f(y|a_1^P, a_2) dy. \quad (12)$$

Thus,  $a_2^A(a_2^P)$  represents the project choice that the agent would take under  $w^P(y|a_1^P, a_2^P)$  described in equation (11) when  $a_2$  is not actually enforceable. Thus, our previous question, "Will the agent voluntarily choose  $a_2^P$  when  $w^P(y|a_1^P, a_2^P)$  is designed?", is equivalent to the question, "Will  $a_2^A(a_2^P)$  be equal to  $a_2^P$ ?"

As previously shown, the principal balances two considerations when he directs the agent to take a certain project: the informational benefits from risk reduction and the lower mean return associated with lower risk. However, the risk level to be chosen by the agent primarily depends on his indirect risk preferences induced by contract  $w^P(y|a_1^P, a_2^P)$ , i.e., the curvature of  $u(w^P(y|a_1^P, a_2^P))$  with respect to  $y$ , and the effect that a trade-off between return and risk would have on his utility via  $w^P(y|a_1^P, a_2^P)$ .

In general, the curvature of the agent's indirect utility function depends on the distribution of the random state variable and utility function itself. To see how different utility functions affect this curvature differently, consider the case where the agent has constant relative risk aversion with degree  $1 - t$ , where  $t < 1$  ( $u(w) = \frac{1}{t} w^t, t < 1$ ). We obtain from equation (11) that

$$w^P(y|a_1^P, a_2^P) = \left( \lambda + \mu_1(a_1^P, a_2^P) \left( \frac{y - \phi(a_1^P, a_2^P)}{(a_2^P)^2} \right) \phi_1(a_1^P, a_2^P) \right)^{\frac{1}{1-t}}, \quad (13)$$

and the agent's indirect utility under this wage contract is

$$u(w^P(y|a_1^P, a_2^P)) = \frac{1}{t} \left( \lambda + \mu_1(a_1^P, a_2^P) \left( \frac{y - \phi(a_1^P, a_2^P)}{(a_2^P)^2} \right) \phi_1(a_1^P, a_2^P) \right)^{\frac{t}{1-t}}. \quad (14)$$

The above equation shows that the agent's indirect utility becomes strictly concave in  $y$  if  $t < \frac{1}{2}$ , linear if  $t = \frac{1}{2}$ , and convex if  $t > \frac{1}{2}$  for  $y$  satisfying  $w^P(y|a_1^P, a_2^P) \geq k$ . If we assume  $w^P(y|a_1^P, a_2^P) = k$  for sufficiently low  $y$ , as far as the agent's induced risk preferences are concerned,  $u(w^P(y|a_1^P, a_2^P))$  makes the agent risk-loving if  $t \geq \frac{1}{2}$ . Furthermore, since the compensation contract  $w^P(y|a_1^P, a_2^P)$  is

positively related to the absolute output level (i.e.,  $\mu_1(a_1^P, a_2^P) > 0$ ),<sup>15</sup> if  $t \geq \frac{1}{2}$ , the agent is induced to take the most risky project, i.e.,  $a_2^A(a_2^P) = \bar{a}_2$  when  $w^P(y|a_1^P, a_2^P)$  is designed even if  $\phi_2(a_1, \bar{a}_2) = 0$  by Assumption 3. However, in this case, principal prefers to have a firm's risk level  $a_2$  lower than  $\bar{a}_2$ . This is because, from his standpoint, the informational benefits from risk reduction are still substantial, while the costs of risk reduction are zero at  $\bar{a}_2$  (i.e.,  $\phi_2(\bar{a}_2) = 0$ ). Thus,  $a_2^P < a_2^A(a_2^P)$  in this case. In other words, the principal prefers less risk than the agent under  $w^P(y|a_1^P, a_2^P)$ .

On the other hand, in the case of  $t$  being close to  $-\infty$  (i.e., the agent is extremely risk-averse), the agent's indirect utility mandates him to choose a lower level of risk than what principal prefers ( $a_2^A(a_2^P) < a_2^P$ ) even though a lower  $a_2$  yields on average a lower output level.<sup>16</sup>

Incentive problems associated with project choice  $a_2$ , in general, exist in all cases except those where both of the following conditions are satisfied: (i) the agent's indirect utility is sufficiently concave and (ii) there is no trade-off between return and risk, i.e.,  $\phi_2 = 0$ ,  $\forall a_2$ . Under these conditions, both the principal and the agent agree that the firm should choose the least risky project, i.e.,  $a_2 = \underline{a}_2$ , and there is no efficiency loss due to the existence of the manager's unobservable project choice. However, when either the agent's induced risk preferences are convex, or the trade-off between return and risk exists as assumed in Assumption 3, the principal and the agent will not generally agree on the firm's optimal project choice, and the compensation contract,  $w^P(y|a_1^P, a_2^P)$ , described in equation (11) will no longer be optimal.

In this situation, the principal must determine the optimal compensation contract by solving the following optimization problem:

$$\begin{aligned} \max_{a_1, a_2, w(\cdot)} & \phi(a_1, a_2) - \int w(y)f(y|a_1, a_2)dy + \lambda \left( \int u(w(y))f(y|a_1, a_2)dy - v(a_1) \right) \quad \text{s.t.} \\ (i) & a_1 \in \arg \max_{a_1'} \int u(w(y))f(y|a_1', a_2)dy - v(a_1'), \quad \forall a_1', \\ (ii) & a_2 \in \arg \max_{a_2'} \int u(w(y))f(y|a_1, a_2')dy - v(a_1), \quad \forall a_2', \\ (iii) & w(y) \geq k, \quad \forall y, \end{aligned} \tag{15}$$

In the above optimization we accounts for the fact that the agent selects  $a_2$  to maximize his own

<sup>15</sup>For this issue, see Holmström (1979), Jewitt (1988) among others.

<sup>16</sup>This issue has been dealt with in literatures including Hirshleifer and Suh (1992), Guay (1999), Ross (2004) among others.

expected utility. If an interior solution for  $(a_1, a_2)$  exists and the first-order approach is valid, the above maximization problem can be expressed as:

$$\begin{aligned} \max_{a_1, a_2, w(\cdot)} & \phi(a_1, a_2) - \int w(y) f(y|a_1, a_2) dy + \lambda \left( \int u(w(y)) f(y|a_1, a_2) dy - v(a_1) \right) \quad \text{s.t.} \\ (i) & \int u(w(y)) f_1(y|a_1, a_2) dy - v'(a_1) = 0, \\ (ii) & \int u(w(y)) f_2(y|a_1, a_2) dy = 0, \\ (iii) & w(y) \geq k, \quad \forall y. \end{aligned} \quad (16)$$

Let  $(a_1^*, a_2^*)$  be the optimal action combination for the above program. Then, by solving the Euler equation, we obtain that the optimal wage contract,  $w^*(y)$ , satisfies,

$$\frac{1}{u'(w^*(y))} = \lambda + \mu_1^* \frac{f_1}{f}(y|a_1^*, a_2^*) + \mu_2^* \frac{f_2}{f}(y|a_1^*, a_2^*), \quad (17)$$

for almost every  $y$  for which equation (17) has a solution  $w^*(y) \geq k$ , and otherwise  $w^*(y) = k$ .  $\mu_1^*$  and  $\mu_2^*$  are the optimized Lagrange multipliers for both incentive constraints, respectively.

Since  $f(y|a_1^*, a_2^*)$  is a normal density function with mean  $\phi(a_1^*, a_2^*)$  and variance  $(a_2^*)^2$ , we have from equation (17) that:

$$\frac{1}{u'(w^*(y))} = \lambda + (\mu_1^* \phi_1^* + \mu_2^* \phi_2^*) \frac{y - \phi(a_1^*, a_2^*)}{(a_2^*)^2} + \mu_2^* \frac{1}{a_2^*} \left( \frac{(y - \phi(a_1^*, a_2^*))^2}{(a_2^*)^2} - 1 \right), \quad (18)$$

for  $y$  satisfying  $w^*(y) \geq k$  and  $w^*(y) = k$  otherwise. In the above equation,  $\phi_i^* \equiv \phi_i(a_1^*, a_2^*)$ ,  $i = 1, 2$ . We call  $w^*(y)$  as an ‘optimal dual-agency contract’ à la [Hirshleifer and Suh \(1992\)](#).

Compared with equation (11), equation (18) shows when both  $a_1$  and  $a_2$  are not observable, the optimal wage contract is based not only on the absolute output  $y$ , but also on its (standardized) deviation from the expected level,  $\frac{(y - \phi(a_1^*, a_2^*))^2}{(a_2^*)^2}$ . Since  $(y - \phi(a_1^*, a_2^*))^2$  is a sample (realized) variance of a single observation with mean zero and variance  $(a_2^*)^2$ , the term  $\frac{(y - \phi(a_1^*, a_2^*))^2}{(a_2^*)^2}$  in equation (18) can be regarded a standardized output deviation. Note that  $\frac{(y - \phi(a_1^*, a_2^*))^2}{(a_2^*)^2} - 1$  is a sufficient statistic for the project choice  $a_2$ , while  $\frac{y - \phi(a_1^*, a_2^*)}{(a_2^*)^2}$  is a sufficient statistic for the productive effort  $a_1$ . By including the sample variance as a contractual parameter, the principal effectively motivates the agent to take

the appropriate level of  $a_2$ , i.e.,  $a_2^*$ .

The optimal dual agency contract is characterized in the following propositions.

**Proposition 1**  $\mu_1^* \phi_1^* + \mu_2^* \phi_2^* > 0$ .

Proposition 1 implies, holding the cash flow variance constant, the manager's payout increases when the firm's cash flow increases, which implies that the manager is rewarded for a higher effort. However, this does not necessarily mean that the contracted payout is monotonically increasing in the output level. For example, if  $\mu_2^* < 0$  in equation (18), the agent can be paid less when the output level is very high.

Thus, a more interesting question has to do with the relation between the agent's rewards and the output deviation, i.e., the sign of  $\mu_2^*$ .

**Proposition 2** *If the principal prefers a less risky project than the agent under  $w^P(y|a_1^P, a_2^P)$  in equation (11), i.e.,  $a_2^P < a_2^A(a_2^P)$ , then the optimal dual agency contract will penalize the agent for having unusual output deviation from the expected level, i.e.,  $\mu_2^* < 0$  for  $w^*(y)$  in equation (18). If the principal prefers a more risky project than the agent under  $w^P(y|a_1^P, a_2^P)$ , i.e.,  $a_2^P > a_2^A(a_2^P)$ , then the optimal dual agency contract will reward the agent for having unusual output deviation, i.e.,  $\mu_2^* > 0$  for  $w^*(y)$  in equation (18).*

If the principal prefers a lower risk level than the agent under the contract  $w^P(y|a_1^P, a_2^P)$ , the contract will be revised in a way that motivates the agent to reduce risk. This can be done by setting  $\mu_2^* < 0$  in equation (18) which penalizes the agent for the unusual output deviation and makes the agent act as if he is more risk-averse. On the other hand, if the principal prefers a higher risk than the agent when  $w^P(y|a_1^P, a_2^P)$  is designed, the contract is revised to motivate the agent to increase risk. This is done by setting  $\mu_2^* > 0$  in equation (18) which rewards the agent for unusual output deviation and makes the agent act as though he is less risk-averse. As discussed earlier, the later case is more likely to occur when the manager is very risk-averse and when the firm's investment opportunities offer a non-trivial trade-off between return and risk.

We denote the optimized joint benefits in this case as

$$SW^*(a_1^*, a_2^*) \equiv \phi(a_1^*, a_2^*) - C^*(a_1^*, a_2^*) - \lambda v(a_1^*), \quad (19)$$



where

$$C^*(a_1^*, a_2^*) \equiv \int [w^*(y) - \lambda u(w^*(y))] f(y|a_1^*, a_2^*) dy \quad (20)$$

denotes the agency cost arising from inducing  $(a_1^*, a_2^*)$  when  $a_3$  is fixed at 0 and  $R$  is observable.

### 3.2 The Principal Does Not Know the Firm's Risk Exposure

We now consider the case in which the firm's exposure to hedgeable risks,  $R$ , is observed only by the agent but not by the principal. Thus, the wage contract cannot explicitly include  $y \equiv x - R\eta$  as a contractual variable. Furthermore, we rule out the possibility of any communication between principal and the agent that allows the agent to reveal  $R$ .<sup>17</sup> We will later consider the case in which communication between the principal and the agent is allowed without cost, and thereby the principal can design a truth-telling mechanism freely.

If principal does not observe  $R$ , the compensation contract must be based on  $(x, \eta)$ , i.e.,  $w = w(x, \eta)$ . The principal's maximization program in this case is thus:<sup>18</sup>

$$\begin{aligned} \max_{a_1(\cdot), a_2(\cdot), w(\cdot)} & \int_R \int_{x, \eta} (x - w(x, \eta)) g(x, \eta | a_1(R), a_2(R), R) h(R) dx d\eta dR \\ & + \lambda \int_R \left( \int_{x, \eta} u(w(x, \eta)) g(x, \eta | a_1(R), a_2(R), R) dx d\eta - v(a_1(R)) \right) h(R) dR \quad \text{s.t.} \\ (i) & \quad a_1(R) \in \arg \max_{a_1} \int_{x, \eta} u(w(x, \eta)) g(x, \eta | a_1, a_2(R), R) dx d\eta - v(a_1), \forall R, \\ (ii) & \quad a_2(R) \in \arg \max_{a_2} \int_{x, \eta} u(w(x, \eta)) g(x, \eta | a_1(R), a_2, R) dx d\eta, \forall R, \\ (iii) & \quad w(x, \eta) \geq k, \quad \forall (x, \eta), \end{aligned} \quad (21)$$

where

$$g(x, \eta | a_1, a_2, R) = \frac{1}{2\pi a_2} \exp \left( -\frac{1}{2} \left[ \frac{(x - \phi(a_1, a_2) - R\eta)^2}{a_2^2} + \eta^2 \right] \right) \quad (22)$$

denotes a joint probability density function of  $(x, \eta)$  given  $(a_1, a_2, R)$  and  $h(R)$  denotes the proba-

<sup>17</sup>In general, communication between principals and agents are likely to be very costly, especially when actually the principal stands for multiple shareholders. For a more detailed discussion of communication costs, see [Laffont and Martimort \(1997\)](#).

<sup>18</sup>In this case as agent is the only one seeing the realized value of  $R$ , his actions  $a_1, a_2$  both depend on  $R$ , given the contract  $w(x, \eta)$ .

bility density function of  $R$ .

Let  $(a_1^N(R), a_2^N(R), w^N(x, \eta))$  be the optimal solution for the above program. The optimized joint benefit in this case is denoted as:

$$SW^N \equiv \int_R [\phi(a_1^N(R), a_2^N(R)) - C^N(a_1^N(R), a_2^N(R)) - \lambda v(a_1^N(R))] h(R) dR, \quad (23)$$

where

$$C^N(a_1^N(R), a_2^N(R)) \equiv \int_{x, \eta} [w^N(x, \eta) - \lambda u(w^N(x, \eta))] g(x, \eta | a_1^N(R), a_2^N(R), R) dx d\eta \quad (24)$$

denotes the agency cost arising from inducing  $(a_1^N(R), a_2^N(R))$  given a realized value of  $R$ .

**Proposition 3** *When there is no derivative market and the communication between the principal and the agent is not possible, the principal's inability to observe the firm's risk exposure reduces welfare, i.e.,*

$$SW^N < SW^*(a_1^*, a_2^*).$$

*Intuitively, when the principal observes the true value of the firm's risk exposure,  $R$ , this information can be used to design a wage contract that eliminates the influence of the hedgeable risks, i.e.,  $w = w^*(y \equiv x - R\eta)$ . However, if  $R$  is not observable and cannot be communicated, this is impossible.*

## 4 When Managers Can Trade Derivatives<sup>19</sup>

This section considers how the introduction of an opportunity to transact derivative contracts (i.e., when  $a_3$  is not fixed at 0) affects the optimal contract and firm's efficiency. Continuing from Section 3.2, we assume that a manager's project choice,  $a_2$ , is not observable. Moreover, we assume that neither a manager's derivatives choice,  $a_3$ , nor firm's risk exposure,  $R$ , can be observed by or communicated to the principal.

Since a firm's exposure to hedgeable risks,  $R$ , is assumed to be known to the agent before he takes actions  $(a_1, a_2, a_3)$ , agent's choice of  $a_3$  can be characterized as his choice of  $b \equiv R - a_3$ . Then given a wage contract, principal can rationally anticipate the agent's choice of  $b = R - a_3$ . We

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<sup>19</sup>This section benefited a lot from the detailed discussion with Seung uk Jang at the University of Chicago.

denote  $\hat{b}$  as the principal's belief of agent's choice of  $R - a_3$ , and define  $z(\hat{b}) \equiv x - \hat{b}\eta$  as a variable that is possibly included in the wage contract, i.e.,  $w(z(\hat{b}))$  is one possible contract. In order for the principal's beliefs to be consistent, it must be the case that the agent actually chooses  $a_3$  satisfying  $b \equiv R - a_3 = \hat{b}$  given the contract (possibly  $w(z(\hat{b}))$ ).

Thus, since

$$z(\hat{b}) \equiv x - \hat{b}\eta = \phi(a_1, a_2) + (b - \hat{b})\eta + a_2\theta, \quad (25)$$

if the principal designs a contract  $w(z(\hat{b}))$  and if the agent actually chooses  $a_3$  satisfying  $b = R - a_3 = \hat{b}$ , then

$$z(\hat{b}) = \phi(a_1, a_2) + a_2\theta = y. \quad (26)$$

Note that a maximum level of joint benefits that can be obtained in this case is  $SW(a_1^*, a_2^*, a_3 = 0)$  in equation (19).<sup>20</sup> Thus, we first consider the case in which the principal designs the contract the same as  $w^*(y)$  described in equation (18) but based on  $z(\hat{b})$  instead of  $y \equiv x - R\eta$ , and examine whether agent chooses  $b \equiv R - a_3 = \hat{b}$  under  $w^*(z(\hat{b}))$ . If this is indeed the case, there is no welfare loss associated with  $R$  (and  $a_3$ ) being unobservable, and this informational benefit is one of the main advantages of letting the agent transact in the derivative market.

Suppose that the principal designs  $w^*(z(\hat{b}))$  satisfying

$$\frac{1}{u'(w^*(z(\hat{b})))} = \lambda + (\mu_1^* \phi_1^* + \mu_2^* \phi_2^*) \frac{z(\hat{b}) - \phi(a_1^*, a_2^*)}{(a_2^*)^2} + \mu_2^* \frac{1}{a_2^*} \left( \frac{(z(\hat{b}) - \phi(a_1^*, a_2^*))^2}{(a_2^*)^2} - 1 \right), \quad (27)$$

for  $z(\hat{b})$  satisfying  $w^*(z(\hat{b})) \geq k$  and  $w^*(z(\hat{b})) = k$  otherwise. Since  $w^*(z(\hat{b}))$  in equation (27) has the same contractual form as  $w^*(y)$  in equation (18),<sup>21</sup> we can easily see that the agent will take  $(a_1^*, a_2^*)$  under  $w^*(z(\hat{b}))$  if he chooses  $a_3$  satisfying  $b \equiv R - a_3 = \hat{b}$ . But, the question is: "Will the agent always choose  $a_3$  satisfying  $b = \hat{b}$  when  $w^*(z(\hat{b}))$  is designed?"

The following Lemma 2 provides an answer to the above question.

**Lemma 2** [Speculation and Hedging with  $w^*(z(\hat{b}))$ ]

<sup>20</sup>Given the contract  $w(z(\hat{b}))$ , if there is no incentive problem associated with  $b = R - a_3$  so the agent voluntarily chooses  $a_3$  such that  $R - a_3 = \hat{b}$ , then we get the maximum joint benefit  $SW(a_1^*, a_2^*, a_3 = 0)$ .

<sup>21</sup>Note that  $\mu_1^*, \mu_1^*, a_1^*, a_2^*$  in equation (18) and equation (27) are endogenous variables characterized by solving the optimization (15).

- (1) If  $\mu_2^* < 0$  for the contract,  $w^*(z(\hat{b}))$ , described in equation (27) for any given  $\hat{b}$ ,<sup>22</sup> then the manager will choose  $a_3$  such that  $b = \hat{b}$  when the contract  $w^*(z(\hat{b}))$  is offered.
- (2) If  $\mu_2^* > 0$  for  $w^*(z(\hat{b}))$  in equation (27) for any given  $\hat{b}$ , then the manager will take  $a_3$  such that  $|R - a_3| = \infty$  when  $w^*(z(\hat{b}))$  is offered.

From Lemma 2, we directly obtain the following proposition:

**Proposition 4** *If  $\mu_2^* < 0$  for  $w^*(z(\hat{b}))$  described in equation (27) for any given  $\hat{b}$ , then the level of  $b \equiv R - a_3$  to be induced is a matter of indifference as long as it is bounded, i.e.,  $|b| < \infty$ . For example, If  $\mu_2^* < 0$  for  $w^*(z(0))$  in equation (27), then the manager will choose  $a_1^*, a_2^*, a_3 = R$  (i.e.,  $b = 0$ ) when  $w^*(z(0))$  is designed. Therefore, optimized joint benefits are the same as  $SW^*(a_1^*, a_2^*)$  in equation (19), implying that the firm's welfare with a derivative market in this case is the same as it is in the case where the risk exposure is observed by the principal.<sup>23</sup>*

Proposition 4 is quite intuitive. If  $\mu_2^* < 0$  for  $w^*(z(\hat{b}))$  in equation (27), the agent is induced to engage in perfect hedging to minimize the variance of  $z(\hat{b})$ . Intuitively, the contract  $w^*(z(\hat{b}))$  with  $\mu_2^* < 0$  induces the agent to sacrifice expected payoffs to lower risk.<sup>24</sup> If the risk can be reduced through a channel that does not decrease the expected payoff (e.g., here  $a_3$  does not have risk-return trade-off.), then agent will clearly do so. In addition,  $\mu_1^* \phi_1^* + \mu_2^* \phi_2^* > 0$  means a higher  $z(\hat{b})$  yields the higher compensation  $w^*(z(\hat{b}))$  given its squared deviation from the average of  $z(\hat{b})$ .

In this case, the optimal contract can be designed as if  $R - a_3$  is observable, and it allows the principal and the agent to achieve the level of welfare  $SW^*(a_1^*, a_2^*)$  that could be achieved when  $R$  is observable. We will discuss more thoroughly about this *informational gain* from the manager's derivative transaction later.

However, this is not possible if  $\mu_2^* > 0$  for  $w^*(z(\hat{b}))$  in equation (27), since the agent will speculate infinitely, i.e., choose  $a_3$  such that  $|R - a_3| = \infty$ . This is because, as shown from equation (27), manager will be paid an infinite amount when  $z(\hat{b}) = x - \hat{b}\eta$  is either positive or negative infinity if  $\mu_2^* > 0$  for  $w^*(z(\hat{b}))$ . Given that it is impossible to design a wage contract  $w^*(z(\hat{b}))$  based on the

<sup>22</sup>One can easily see that if  $\mu_2^* < 0$  in  $w^*(z(\hat{b}))$  for any given  $\hat{b}$ , then  $\mu_2^* < 0$  in  $w^*(z(\hat{b}))$  for all  $\hat{b}$ . This is because the principal's anticipating different  $\hat{b}$  does not change the functional form of  $w^*(\cdot)$ .

<sup>23</sup>Therefore, an introduction of derivative markets in this case improves the welfare compared with the case where the principal does not observe the firm's risk exposure  $R$  and the communication between the principal and the agent is prohibitively costly. It comes from  $SW^*(a_1^*, a_2^*) > SW^N$  in Proposition 3.

<sup>24</sup>Since the optimal contract  $w^*(z(\hat{b}))$  features  $\mu_2^* < 0$  when  $a_2^P < a_2^A(a_2^P)$  holds.

belief  $\hat{b} = \infty$ , the principal has to either alter the wage contract to ensure  $|R - a_3| < \infty$  or retain the optimal contract without a derivative market,  $w^N(x, \eta)$  and prohibit the manager from engaging in derivative transactions, if possible.

To derive an optimal contract in the presence of derivative market when  $\mu_2^* > 0$  for  $w(z(\hat{b}))$  in equation (27), we first consider the case in which the principal decides to design a contract that ensures a finite  $a_3$  when  $\mu_2^* > 0$  for  $w^*(z(\hat{b}))$  in equation (27). Actually, there is a class of compensation contracts that ensure a finite  $a_3$ , depending on which  $a_3$  is to be induced. Let  $(a_1^o, a_2^o, a_3^o)$ , where  $|b^o \equiv R - a_3^o| < \infty$ , be the optimal action combination and  $\underline{w^o(z(\hat{b}), \eta)}$  be the wage contract which optimally induces that action combination where  $\hat{b} = b^o \equiv R - a_3^o$ . We denote the optimized joint benefits in this case as

$$SW^o(a_1^o, a_2^o, a_3^o) \equiv \phi(a_1^o, a_2^o) - C^o(a_1^o, a_2^o, b^o) - \lambda v(a_1^o), \quad (28)$$

where

$$C^o(a_1^o, a_2^o, b^o) \equiv \int [w^o(z(\hat{b}), \eta) - \lambda u(w^o(z(\hat{b}), \eta))] g(z(\hat{b}), \eta | a_1^o, a_2^o, b^o) dz d\eta \quad (29)$$

denotes the agency cost arising from inducing  $(a_1^o, a_2^o, a_3^o)$  when there is a derivative market and  $\mu_2^* > 0$  for  $w^*(z(\hat{b}))$  in equation (27).

**Lemma 3** *If  $w^o(z(\hat{b}), \eta)$  is an optimal contract that actually induces  $(a_1^o, a_2^o, a_3^o)$  where  $\hat{b} = R - a_3^o \equiv b^o \neq 0$ , then  $w^o(z(0), \eta) \equiv w^o(x, \eta)$ <sup>25</sup> is also an optimal contract which induces  $(a_1^o, a_2^o, a_3 = R)$ . Therefore,*

$$SW^o(a_1^o, a_2^o, a_3^o) = SW^o(a_1^o, a_2^o, a_3 = R).$$

Lemma 3 indicates that when the principal has to design a compensation contract to guarantee the agent's choice of  $a_3$  satisfying  $|R - a_3| < \infty$  due to the fact that  $\mu_2^* > 0$  for  $w^*(z(\hat{b}))$ , the level of  $a_3$  to be induced by  $w^o(z(\hat{b}), \eta)$  is a matter of indifference as long as it is finite. This is because, as shown in equation (25), the agent's derivative choice,  $a_3$ , is additively separable from his other two productive action choices,  $(a_1, a_2)$ , in determining the output level,  $x$ , and not only the output level but also the derivative market variables,  $\eta$ , are observable (thus contractible).

From Lemma 3, we know that the wage contract which induces the agent to hedge completely,

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<sup>25</sup>Note that  $z(0) = x$  from equation (25).

$b = 0$ , i.e.,  $w^o(z(0), \eta) \equiv w^o(x, \eta)$ , is one of the optimal contracts among the wage contracts that ensure  $|R - a_3 = \hat{b}| < \infty$  when  $\mu_2^* > 0$  for  $w^*(z(\hat{b}))$ . Thereby without loss of generality, we only characterize  $w^o(x, \eta)$  that induces  $b = 0$  (i.e.,  $a_3 = R$ ). Actually,  $w^o(x, \eta)$  is obtained by solving a maximization problem that is similar to equation (16) with an added requirement that a contract induces the manager to take  $a_3 = R$ .

Given that the agent's choosing  $a_3$  is equivalent to his choosing  $b = R - a_3$ , new optimal contract,  $w^o(x, \eta)$ , inducing the agent to take  $(a_1^o, a_2^o, b = 0)$  when  $\mu_2^* > 0$  for  $w^*(z(\hat{b}))$  in equation (27), with  $(a_1^o, a_2^o)$ , must solve the following optimization problem:

$$\begin{aligned} \max_{a_1, a_2, w(\cdot)} & \int (x - w(x, \eta))g(x, \eta|a_1^o, a_2^o, b = 0)dx d\eta + \lambda \left( \int u(w(x, \eta))g(x, \eta|a_1^o, a_2^o, b = 0)dx d\eta - v(a_1^o) \right) \quad \text{s.t.} \\ & (i) \quad \int u(w(x, \eta))g_1(x, \eta|a_1^o, a_2^o, b = 0)dx d\eta - v'(a_1^o) = 0, \\ & (ii) \quad \int u(w(x, \eta))g_2(x, \eta|a_1^o, a_2^o, b = 0)dx d\eta = 0, \\ & (iii) \quad b = 0 \in \arg \max_{b'} \int u(w(x, \eta))g(x, \eta|a_1^o, a_2^o, b')dx d\eta, \quad \forall b', \\ & (iv) \quad w(x, \eta) \geq k, \quad \forall (x, \eta). \end{aligned} \tag{30}$$

Note that we use the first-order approach for incentive constraints associated with action  $a_1$  and the project choice  $a_2$ , while we do not use the same approach for the incentive constraint associated with  $b$ . The following Lemma 4 demonstrates the reason we cannot use the first-order approach for the incentive constraint of  $b$ .

**Lemma 4** *If  $w^*(z(0))$  in equation (27) is designed, the agent will be indifferent between taking  $b$  and taking  $-b$ ,  $\forall b$ .*

Lemma 4 shows, if  $w^*(z(0))$  is designed and offered, manager's expected utility becomes symmetric around  $b = 0$  (i.e.,  $a_3 = R$ ) in the space of  $b$  (i.e., in the space of  $a_3$ ). We know:

$$\int u(w^*(z(0)))g(z(0), \eta|a_1^o, a_2^o, b)dz d\eta \tag{31}$$

is continuous and differentiable in  $b$ , Lemma 4 implies:

$$\int u(w^*(z(0)))g_3(z(0), \eta|a_1^o, a_2^o, b = 0)dz d\eta = 0, \tag{32}$$

where  $g_3$  denotes the first derivative of  $g$  taken with respect to  $b$ . Since  $w^*(z(0))$  is the solution of the following optimization without the incentive constraint of  $b$ ,<sup>26</sup>

$$\begin{aligned} \max_{w(\cdot)} & \int (x - w(x, \eta)) g(x, \eta | a_1^o, a_2^o, b = 0) dx d\eta + \lambda \left( \int u(w(x, \eta)) g(x, \eta | a_1^o, a_2^o, b = 0) dx d\eta - v(a_1^o) \right) \quad \text{s.t.} \\ & (i) \quad \int u(w(x, \eta)) g_1(x, \eta | a_1^o, a_2^o, b = 0) dx d\eta - v'(a_1^o) = 0, \\ & (ii) \quad \int u(w(x, \eta)) g_2(x, \eta | a_1^o, a_2^o, b = 0) dx d\eta = 0, \\ & (iii) \quad w(x, \eta) \geq k, \quad \forall (x, \eta). \end{aligned} \quad (34)$$

if we use the first-order approach for the incentive constraint associated with  $b$  in the above program (30), we always end up with getting  $w^*(z(0))$  in equation (27) as an optimal contract for the above program. However, since  $\mu_2^* > 0$  for  $w^*(z(0))$ , we can easily see from Lemma 2 that this contract incentivizes an agent to take  $b = \pm\infty$  instead of taking a stipulated  $b = 0$ .<sup>27</sup> Therefore, we have to explicitly include the incentive constraint for  $b$  which does not rely only on the first-order condition at  $b = 0$ .

Without relying on the first-order approach and following Grossman and Hart (1983), we replace the incentive constraint for  $b$  (i.e., (iii) in (30)) by:

$$\int u(w(x, \eta)) (g(x, \eta | a_1^o, a_2^o, b = 0) - g(x, \eta | a_1^o, a_2^o, b)) dx d\eta \geq 0, \quad \forall b, \quad (35)$$

which implies that the manager's indirect utility is maximized when he takes  $b = 0$  (i.e.,  $a_3 = R$ ).

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<sup>26</sup>Since for  $b = 0$ , the likelihood ratios can be represented as

$$\begin{aligned} \frac{g_1}{g}(x, \eta | a_1, a_2, b = 0) &= \frac{x - \phi(a_1, a_2)}{a_2^2} \phi_1(a_1, a_2), \quad \frac{g_3}{g}(x, \eta | a_1, a_2, b = 0) = \frac{(x - \phi(a_1, a_2))\eta}{a_2^2}, \\ \frac{g_2}{g}(x, \eta | a_1, a_2, b = 0) &= -\frac{1}{a_2} + \frac{x - \phi(a_1, a_2)}{a_2^2} \phi_2(a_1, a_2) + \frac{(x - \phi(a_1, a_2))^2}{a_2^3}, \end{aligned} \quad (33)$$

we see that  $w^*(z(0))$  becomes the solution of the equation (34) without the incentive constraint of  $b$ .

<sup>27</sup>The same technical problem about the first-order approach does not arise from the incentive constraint of  $a_2$ , which also determines the firm's risks. This is because reducing risk through  $a_2$  is costly in terms of return, while doing it through  $a_3$  is not. Thus, the manager's expected utility is not symmetric in the space of  $a_2$ .

Now we state formally the optimization problem of choosing the optimal  $(a_1^o, a_2^o)$  and  $w^o(\cdot)$  as:

$$\begin{aligned} \max_{w(\cdot)} & \int (x - w(x, \eta)) g(x, \eta | a_1^o, a_2^o, b = 0) dx d\eta + \lambda \left( \int u(w(x, \eta)) g(x, \eta | a_1^o, a_2^o, b = 0) dx d\eta - v(a_1^o) \right) \quad \text{s.t.} \\ (i) & \int u(w(x, \eta)) g_1(x, \eta | a_1^o, a_2^o, b = 0) dx d\eta - v'(a_1^o) = 0, \\ (ii) & \int u(w(x, \eta)) g_2(x, \eta | a_1^o, a_2^o, b = 0) dx d\eta = 0, \\ (iii) & \int u(w(x, \eta)) (g(x, \eta | a_1^o, a_2^o, b = 0) - g(x, \eta | a_1^o, a_2^o, b)) dx d\eta \geq 0, \quad \forall b, \\ (iv) & w(x, \eta) \geq k, \quad \forall (x, \eta). \end{aligned} \tag{36}$$

Note that the set of incentive constraints for all  $b$  (i.e., (35)) are taken into account to make sure the agent's expected indirect utility is at maximum when he chooses  $b = 0$  instead of other  $b > 0$  or  $b < 0$ .

By solving the Euler equation which is derived from the above program, the optimal contract,  $w^o(x, \eta)$ , must satisfy<sup>28</sup>

$$\begin{aligned} \frac{1}{u'(w^o(x, \eta))} = & \lambda + (\mu_1^o \phi_1^o + \mu_2^o \phi_2^o) \frac{x - \phi(a_1^o, a_2^o)}{(a_2^o)^2} + \mu_2^o \frac{1}{a_2^o} \left( \frac{(x - \phi(a_1^o, a_2^o))^2}{(a_2^o)^2} - 1 \right) \\ & + \underbrace{\int \mu_4^o(b) \left( 1 - \frac{g(x, \eta | b)}{g(x, \eta | b = 0)} \right) db}_{\text{Additional term to equation (27)}}, \end{aligned} \tag{37}$$

for  $(x, \eta)$  satisfying  $w^o(x, \eta) \geq k$  and  $w^o(x, \eta) = k$  otherwise. In equation (37),  $\phi_i^o \equiv \phi_i(a_1^o, a_2^o)$ ,  $i = 1, 2$ , and  $\mu_1^o$ ,  $\mu_2^o$ , and  $\mu_4^o(b)$  are the optimized Lagrange multipliers associated with the first, second, and third constraints (for specific  $b$ ) in the above optimization program, respectively.<sup>29</sup>

As shown in the Appendix, we obtain the following proposition from (37).

**Proposition 5 [Hedging through Punishment]**

*If  $\mu_2^* > 0$  for  $w^*(z(0))$  described in equation (27), then the principal can motivate the manager to hedge completely by designing a new compensation contract,  $w^o(x, \eta)$  in equation (37), which (i) satisfies  $w^o(x, \eta) = w^o(x, -\eta)$  for all  $x, \eta$ , and (ii) penalizes the manager for having any (positive or negative) sample covariance between the output,  $x$ , and derivative market observables,  $\eta$  (i.e., penalizing manager for having high*

<sup>28</sup>We suppress the dependence of distribution  $g$  and likelihood ratios on  $(a_1^o, a_2^o)$ .

<sup>29</sup>For general reference about the variational approach to the optimization (36), see Luenberger (1969).



$(x - \phi)^2 \eta^2$ ). To be specific, given realized  $(x, \eta)$ , a higher sample covariance  $(x - \phi)^2 \eta^2$  yields a lower wage  $w^o(x, \eta)$ , while given the output  $x$  and sample covariance  $(x - \phi)^2 \eta^2$ , a higher  $\eta$  raises the wage  $w^o(x, \eta)$ .

Proposition 5 can be understood in the following way: the production function  $x = \phi(a_1^o, a_2^o) + a_2 \theta + b \eta$  gives us the relation  $b = \text{Cov}(x, \eta) = \mathbb{E}((x - \phi(a_1^o, a_2^o))\eta)$ . It implies that if the agent takes  $b = 0$ , a statistical covariance between output  $x$  and hedgeable risk  $\eta$  disappears, whereas any other  $b \neq 0$  generates non-zero population covariances. Since  $b = 0$  generates  $x = \phi(a_1^o, a_2^o) + a_2 \theta$ , which is independent of  $\eta$ ,  $w^o(x, \eta) = w^o(x, -\eta)$  for all  $x, \eta$  is ensured to minimize the amount of risk imposed on the agent, as  $\eta$  becomes irrelevant in inducing  $(a_1^o, a_2^o)$  and has a symmetric distribution around 0.

At optimum, by punishing the covariance between  $x$  and  $\eta$ ,<sup>30</sup> shareholders effectively incentivize the manager to engage in full hedging and take  $b = 0$ . As our framework is in one-period setting, any positive or negative realized sample covariance  $\widehat{\text{Cov}} = (x - \phi(a_1^o, a_2^o))\eta = b\eta^2 + a_2\theta\eta$ , instead of a population covariance, is punished by the principal through a lower compensation  $w^o(x, \eta)$ . If the realized sample covariance  $\widehat{\text{Cov}} = (x - \phi(a_1^o, a_2^o))\eta = b\eta^2 + a_2\theta\eta$  is large, not because of the manager's speculation ( $b \neq 0$ ) but from a high realized market observable,  $|\eta|$ , then the principal takes it into account and raises  $w^o(x, \eta)$ . In contrast, given realized output and market observables  $(x, \eta)$ , a bigger realization of  $\widehat{\text{Cov}}$  is likely to be generated by  $b \neq 0$  with a bigger  $|b|$ , thus the agent is punished and her wage income  $w^o(x, \eta)$  falls.

Designing the new optimal contract including this covariance punishment is not, however, costless compared with  $w^N(x, \eta)$  in equation (24), the optimal contract in case where there is no derivative market, since it exposes the agent to additional risks. As we show below, if this cost is relatively high compared to the informational gain that principal gets through the agent's derivative transaction, an introduction of derivative markets can actually reduce the welfare.

**Proposition 6** *If  $\mu_2^* > 0$  for  $w^*(z(0))$  in equation (27), the introduction of a derivative market will reduce the firm's welfare compared with  $SW^N$  in equation (23) when the amount of uncertainty about the firm's risk exposure,  $\sigma_R^2$ , is small.*

As we show in Proposition 4, the optimal contract must be altered from  $w^N(x, \eta)$  in the presence of derivative markets. In cases where the manager voluntarily chooses to hedge after the derivative

<sup>30</sup>It is possible since  $\eta$  is observable at the end of the period and thus contracts can be written upon it.

market is introduced given his original optimal dual-agency contract (i.e.,  $\mu_2^* < 0$  for  $w^*(y)$  in (18) or equivalently  $\mu_2^* < 0$  for  $w^*(z(0))$  in (27)), the compensation contract remains mainly unchanged from  $w^*(y)$  while being based on  $z(0) = x$  rather than  $y$ , and the welfare unambiguously increases by the informational gain generated by an opportunity of the manager to hedge in the derivative market and eliminate the firm's risk exposure  $R$ . However, when  $w^*(z(0))$  with  $\mu_2^* > 0$  induces the manager to speculate in the derivative market, shareholders must revise the manager's contract to  $w^o(x, \eta)$  to provide the manager with an incentive to hedge, which imposes additional risks on the risk-averse manager's side and incurs the cost out of it. Thus, there are costs and benefits associated with derivative trading that the principal must consider.

Altering the wage contract to ensure that the agent hedges rather than speculates is costly since it needs to consider the agent's additional incentive problem associated with  $a_3$  by exposing him to the additional risk: market observables  $\eta$ , whereas the principal gets informational benefits as now she does not have to know about the firm's risk exposure  $R$  as the agent eliminates any hedgeable risk (i.e.,  $b = 0$  or  $a_3 = R$ ) under  $w^o(x, \eta)$ . On the other hand, when there is no derivative market, principal's inability to observe  $R$  causes welfare loss because now she should offer  $w^N(x, \eta)$  instead of  $w^*(y)$ .<sup>31</sup> To illustrate these costs and benefits more precisely, we use equation (19), equation (23), and equation (28), and decompose the welfare change in the following way.

$$SW^o(a_1^o, a_2^o) - SW^N = \left( SW^*(a_1^*, a_2^*) - SW^N \right) - \left( SW^*(a_1^*, a_2^*) - SW^o(a_1^o, a_2^o, R) \right). \quad (38)$$

The first part in the right-hand side represents the welfare loss due to the principal's inability to observe the firm's risk exposure when there is no derivative market (or equivalently informational gains from the introduction of a derivative market). The second part represents welfare loss due to the additional incentive problem associated with the manager's derivative choices when the derivative market is introduced and the manager speculates under  $w^*(z(0))$  in equation (27).

Note that no expectation with respect to  $R$  is taken for joint benefits  $SW^*(a_1^*, a_2^*)$  and  $SW^o(a_1^o, a_2^o, a_3 = R)$ , since both of them are independent of  $R$ . When there is no derivative market and the firm's risk exposure,  $R$ , is observed by the principal as well as the manager, joint benefits,  $SW^*(a_1^*, a_2^*)$ , are obviously independent of the  $R$ 's realization because  $(a_1^*, a_2^*)$  are independent of  $R$ . Likewise, when

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<sup>31</sup>Of course, principal can always design  $w^o(x, \eta)$  instead of  $w^N(x, \eta)$  when there is no derivative market. However,  $w^o(x, \eta)$  will perform poorly without the derivative market.

$w^o(x, \eta)$  is designed in the presence of derivative markets, the joint benefits  $SW^o(a_1^o, a_2^o, a_3 = R)$  are independent of  $R$  as agent is always induced to take  $b = R - a_3 = 0$  no matter what  $R$  is realized. However, in calculating joint benefits  $SW^N$ , an expectation with respect to  $R$  is taken, implying that the distribution of  $R$  affects the level of  $SW^N$ .

The above discussion implies that informational gains from the manager's derivative transaction declines as the amount of uncertainty around the firm's risk exposure  $R$  falls. On the other hand, the cost of controlling the additional incentive problem associated with  $a_3$  (or equivalently  $b = R - a_3$ ) is independent of the firm's risk exposure  $R$  and thus  $\sigma_R^2$ . For instance, even if  $R$  is known to the principal (i.e.,  $\sigma_R^2 = 0$ ), the moral hazard problem associated with inducing  $b = 0$  still remains to the same degree. Therefore, the amount of uncertainty on  $R$  is indeed a matter of indifference in incentivizing the agent's choice of  $b$ .

As a result, if the uncertainty around  $R$  is small enough, the contractual cost dominates informational gains when derivative markets are introduced, and shareholders would be better off by prohibiting the manager from trading derivatives at all. Therefore, recent financial innovations have potentials to hurt the efficiency of firms through its effects on agency relationships.

## 5 The Truth-Telling Mechanism

Up to this point we have assumed that there is no communication between principal and agent after compensation contract is written, due to high communication costs. We now relax this assumption and consider the case where the agent can costlessly communicate the firm's risk exposure  $R$  to the principal, and receive a payoff that is contingent on the communicated risk exposure as well as the output and hedgeable risks.

As we will show below, for the case where  $\mu_2^* < 0$  for  $w^*(z(0))$  in equation (27), a contract that is similar to  $w^*(z(0))$  can be designed to induce the agent to truthfully reveal the firm's risk exposure  $R$ . In other words, there is no loss associated with the risk exposure being unobservable and thus no gain from the introduction of derivative market. The intuition is the same as the one for why the manager would voluntarily hedge under  $w^*(z(0))$  with  $\mu_2^* < 0$ . Essentially, the truth-telling contract allows the agent to make a *side bet* with the principal and if the agent hedges in the

derivative market with the contract  $w^*(z(0))$ , he will truthfully reveal what he observes (true  $R$ ) to minimize the additional risk associated with this side bet.

However, when  $\mu_2^* > 0$  for  $w^*(z(0))$  in equation (27), a contract similar to  $w^*(z(0))$  does not induce truth-telling since the manager wants to add more risks, as he does by engaging in speculation in derivative markets. Again, a new contract must be designed to induce him to reveal the truth.

Suppose the principal does not know the firm's innate risk exposure  $R$  and there is no derivative market (i.e.,  $a_3$  is again fixed at 0). Since the agent observes  $R$  before he takes  $(a_1, a_2)$  and communication regarding  $R$  is freely allowed, the principal can design a truth-telling mechanism,  $w(x, r, \eta)$ , without incurring cost where  $r$  represents the value of  $R$  reported by the agent. Let  $(a_1^T(R), a_2^T(R))$  be agent's optimal action combination after observing  $R$  and  $w^T(x, r, \eta)$  be the wage contract that optimally induces  $(a_1^T(R), a_2^T(R))$  with the agent telling the truth. Knowing that  $r = R, \forall R$ , under  $w^T(x, r, \eta)$ , we denote optimized joint benefits in this case as

$$SW^T \equiv \int \left( \phi(a_1^T(R), a_2^T(R)) - C^T(a_1^T(R), a_2^T(R)) - \lambda v(a_1^T(R)) \right) h(R) dR, \quad (39)$$

where

$$C^T(a_1^T(R), a_2^T(R)) \equiv \int \left( w^T(x, R, \eta) - \lambda u(w^T(x, R, \eta)) \right) g(x, \eta | a_1^T(R), a_2^T(R)) dx d\eta \quad (40)$$

denotes the agency cost arising from inducing  $(a_1^T(R), a_2^T(R))$  through  $w^T(x, r, \eta)$  when  $R$  is realized. In the above equation,  $g(x, \eta | a_1^T(R), a_2^T(R))$  denotes the joint density function of  $(x, \eta)$  given that  $(a_1^T(R), a_2^T(R))$  is chosen by the manager when  $a_3$  is fixed at 0.

Since  $SW^*(a_1^*, a_2^*)$  in (19) is the maximum level of joint benefits that  $SW^T$  can attain, we first consider the case in which principal designs a wage contract,  $w^*(y_r)$ , that is the same as  $w^*(y)$  in (17) except that it is based on  $y_r \equiv x - r\eta$  instead of  $y \equiv x - R\eta$ . That is,  $w^*(y_r)$  satisfies

$$\frac{1}{u'(w^*(y_r))} = \lambda + (\mu_1^* \phi_1^* + \mu_2^* \phi_2^*) \frac{y_r - \phi(a_1^*, a_2^*)}{(a_2^*)^2} + \mu_2^* \frac{1}{a_2^*} \left( \frac{(y_r - \phi(a_1^*, a_2^*))^2}{(a_2^*)^2} - 1 \right), \quad (41)$$

for  $y_r$  satisfying  $w^*(y_r) \geq k$  and  $w^*(y_r) = k$  otherwise. We call  $w^*(y_r)$  the *full-trust contract* as  $w^*(y_r)$  simply is based on the agent's report instead of the realized  $R$  in (41).

Note that

$$y_r \equiv x - r\eta = \phi(a_1, a_2) + (R - r)\eta + a_2\theta. \quad (42)$$

Since, from (25),

$$z(0) = x = \phi(a_1, a_2) + (R - a_3)\eta + a_2\theta, \quad (43)$$

the principal's problem of designing a truth-telling mechanism based on  $y_r$  when there is no derivative market is equivalent to his problem of designing an incentive scheme based on  $z(0)$  to induce  $b = 0$  (i.e.,  $a_3 = R$ ) when derivative transactions are allowed. As a result, as is the case for  $w^*(z(0))$  in Lemma 2, we directly obtain following results for  $w^*(y_r)$ .

**Lemma 5** [Speculation and Hedging with  $w^*(y_r)$ ]

- (1) If  $\mu_2^* < 0$  for the wage contract,  $w^*(y_r)$ , described in equation (41), then the manager will always report truly, i.e.,  $r = R, \forall R$ , when  $w^*(y_r)$  is offered.
- (2) If  $\mu_2^* > 0$  for  $w^*(y_r)$ , then the manager will report  $r$  such that  $|R - r| = \infty$  when  $w^*(y_r)$  is offered.

From Lemma 5, we obtain the following propositions.

**Proposition 7** When there is no derivative market and communication between principal and agent is costless, then  $w^*(y_r)$  described in equation (41) is the optimal truth-telling mechanism for the firm's hidden risk exposure,  $R$ , if  $\mu_2^* < 0$  for  $w^*(y_r)$ . In this case:

- (1) The principal's inability to observe  $R$  does not reduce the firm's welfare (i.e., no adverse selection).
- (2) An introduction of a derivative market does not improve the firm's welfare compared with  $SW^T$  in (39).

Proposition 7 along with Propositions 3 and 4 reaffirms that the benefits that derivative markets bring are actually informational gains, as the agent engages in the perfect hedging in the derivative market. Because we assumed initially that principal and agent cannot communicate with each other due to the huge cost, these benefits are actually associated with saving communication costs<sup>32</sup> that would realistically incur when principal has to design a truth-telling contract that induces the agent to reveal his exact information about the firm's risk exposure  $R$ . When the communication between principal and agent becomes free, the principal, by designing  $w^*(y_r)$ , can easily reproduce the same

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<sup>32</sup>In the presence of derivative markets, principal and agent do not need to communicate about the realized  $R$ , since the agent can eliminate this innate risk  $R$  through derivative transactions (i.e.,  $a_3 = R$ ).

results as when he exactly knows the firm's innate risk exposure if  $\mu_2^* < 0$  for  $w^*(y_r)$ . However, in reality, the costs associated with communicating this information and updating the compensation contract based on the revealed  $R$  may be greater than the hedging cost. As shown in (42), allowing the manager to choose  $a_3$  in derivative transactions is observationally equivalent to allowing him to freely report the firm's realized risk exposure  $R$ .

On the other hand, if  $\mu_2^* > 0$  for  $w^*(y_r)$ , the manager does not report the true  $R$  under  $w^*(y_r)$ , and shareholders have to redesign a truth-telling mechanism,  $w^T(x, r, \eta)$  different from  $w^*(y_r)$ .

**Proposition 8** *When  $\mu_2^* > 0$  for  $w^*(y_r)$  described in equation (41), the introduction of a derivative market does not improve on the firm's efficiency when communication between the principal and the agent is freely allowed, and it actually lowers the firm's efficiency if  $\sigma_R^2$  is very small.*

As explained in Proposition 6, when communication between shareholders and manager is not available and  $\mu_2^* > 0$  for  $w^*(y_r)$  in (27), the manager's opportunity to transact derivatives may or may not improve the firm's welfare compared to the case without the derivative market depending on the size of uncertainty  $\sigma_R^2$  on the exposure  $R$ .

If communication becomes free between principal and agent however, an access to the derivative market actually reduces the firm's welfare when  $\sigma_R^2$  is small enough. It is because both  $w^o(x, \eta)$  in (37) and  $w^N(x, \eta)$  in (24)<sup>33</sup> are actually truth-telling contracts. Therefore, when there is no derivative market, the principal can at least design either  $w^o(x, \eta)$  or  $w^N(x, \eta)$  under free communication depending on which of two gives the better welfare.<sup>34</sup> As shown in Proposition 6, the principal prefers designing  $w^N(x, \eta)$  to  $w^o(x, \eta)$  if  $\sigma_R^2$  is very small. The optimal truth-telling mechanism,  $w^T(x, r, \eta)$ , thus performs weakly better than  $w^N(x, \eta)$ , which yields strictly larger welfare than  $w^o(x, \eta)$ . However, after the derivative market is introduced, the principal has to shift from  $w^T(x, r, \eta)$  to  $w^o(x, \eta)$  because there now exists an incentive problem associated with  $a_3$ .

In summary, when communication between shareholders and manager becomes free, the manager's access to derivative market transactions does not change the firm's welfare if  $\mu_2^* < 0$ , and even lowers it if  $\mu_2^* > 0$ .

<sup>33</sup>Note that both  $w^o(x, \eta)$  and  $w^N(x, \eta)$  do not depend on the reported value of  $R$ , so we regard both two contracts as truth-telling mechanism.

<sup>34</sup>The optimal truth-telling mechanism in this case may not be  $w^o(x, \eta)$  or  $w^N(x, \eta)$ .

## 6 Conclusion

As the previous global financial crisis (GFC) hit the world, interests in (i) risk management and (ii) welfare implications of new developments in financial markets have increased dramatically. Since then, academics and policymakers proposed a number of explanations for the economy-wide effects of new innovations in financial markets, ways to manage corporate risks, and rationales for more strict regulations. However, up to our knowledge, few prior works have seriously attempted to connect this trend with the managerial incentive aspects. In line with the former Federal Reserve chairman Ben Bernanke's emphasis on the role of 'compensation structures' in many banking sector corporations in generating excessive risks<sup>35</sup>, this agency aspect should be taken into account more seriously when we try to understand the implication of financial market innovations in relation to risk-management issues.

Many corporations in *Wall street* and the *Main Street* have used various forms of compensation contracts to motivate their workers to engage in innovations. However, under certain circumstances, as illustrated by the shadow banking industry during the global financial crisis (GFC), managers of those companies speculate rather than hedge, if compensation contracts are not modified to account for unobservable opportunities to alter the firm's risk exposures. When compensation contracts do need to be modified, some efficiency gains associated with the introduction of hedging instruments is lessened because the new contractual form may less efficiently share risk between the manager and shareholders and induce the efforts. Indeed, our analysis suggests that in some circumstances, the incentive costs associated with keeping the agent from speculating in the derivative market is sufficiently large that firms would be better off by prohibiting derivative transactions. This point is understood in line with the last decade's hard works of governments, central banks, and international institutions to curb the degree of risk-taking through regulations on incentive compensation schemes. For example, 2010's 'Dodd-Frank Wall Street Reform and Consumer Protection Act, section 956, mandates that agencies must prohibit all covered institutions from establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risk-taking.<sup>36</sup>

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<sup>35</sup>Ben Bernanke, the former Fed chair, said "The Federal Reserve is working to ensure that compensation packages appropriately tie rewards to longer-term performance and do not create undue risk for the firm or the financial system." <https://www.nytimes.com/2009/10/23/business/23pay.html>

<sup>36</sup>Federal Reserve's 06.21.2010 joint press said, "Last month, the Federal Reserve delivered assessments to the firms that included analysis of current compensation practices and areas requiring prompt attention. Firms are submitting

We stress that while we focused on an agency relationship, improving the information content of a firm's cash flows by reducing the risk can improve firm values in a number of different ways. For example, a lower risk provides better information about the managers' abilities as well as their effort levels, which allows shareholders to better match managers with appropriate positions. In addition, more informative cash flows are likely to improve the informational efficiency of firms' share prices. With more informative stock prices, capitals are allocated more efficiently and managers have less incentive to take short-sighted actions and in other ways expend resources signalling their firms' values.

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plans to the Federal Reserve outlining steps and timelines for addressing outstanding issues to ensure that incentive compensation plans do not encourage excessive risk-taking."



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## Appendix. Derivations and Proofs

**Proof of Lemma 1:** We know from  $y \sim N(\phi(a_1, a_2), a_2^2)$  that

$$\frac{y - \phi(a_1, a_2)}{a_2} \sim N(0, 1), \quad \frac{f_1}{f}(y|a_1, a_2) = \frac{y - \phi(a_1, a_2)}{a_2^2} \phi_1(a_1, a_2) \sim N(0, \frac{\phi_1(a_1, a_2)^2}{a_2^2}). \quad (\text{A1})$$

Therefore, we observe that if  $\frac{\phi_1(a_1, a_2)}{a_2}$  is decreasing in  $a_2$ , for any pair  $a_2^0 < a_2^1$ ,  $\frac{f_1}{f}(y|a_1, a_2^0)$ 's distribution is mean-preserving spread (MPS) of that of  $\frac{f_1}{f}(y|a_1, a_2^1)$ . Assumption 5 guarantees this condition holds, and Kim (1995) proves  $C(a_1, a_2^0) < C(a_1, a_2^1)$  for  $\forall a_1$ .  
■

**Derivation of equation (10):**

Given  $a_1 = a_1^P$  (fixed),  $\phi_2(a_1^P, a_2^P) = C_2(a_1^P, a_2^P)$  holds at optimum. We can write  $C_2(a_1^P, a_2^P)$  in the following way:

$$\begin{aligned} \phi_2(a_1^P, a_2^P) = C_2(a_1^P, a_2^P) &= \int \left( w^P(y|a_1^P, a_2^P) - \lambda u(w^P(y|a_1^P, a_2^P)) \right) f_2(y|a_1^P, a_2^P) dy \\ &\quad + \int \left( \frac{\partial w^P}{\partial a_2}(y|a_1^P, a_2^P) - \lambda u'(\frac{\partial w^P}{\partial a_2}(y|a_1^P, a_2^P)) \right) f(y|a_1^P, a_2^P) dy, \end{aligned} \quad (\text{A2})$$

where we know the following equation is satisfied:<sup>1</sup>

$$\begin{aligned} \frac{\partial w^P}{\partial a_2}(y|a_1^P, a_2^P) - \lambda u'(\frac{\partial w^P}{\partial a_2}(y|a_1^P, a_2^P)) &= \frac{\partial w^P}{\partial a_2}(y|a_1^P, a_2^P) \left( 1 - \lambda u'(\frac{\partial w^P}{\partial a_2}(y|a_1^P, a_2^P)) \right) \\ &= \frac{\partial w^P}{\partial a_2}(y|a_1^P, a_2^P) \cdot \mu_1(a_1^P, a_2^P) \frac{f_1}{f}(y|a_1^P, a_2^P) u'(\frac{\partial w^P}{\partial a_2}(y|a_1^P, a_2^P)). \end{aligned} \quad (\text{A3})$$

Thus by plugging equation (A3) into equation (A2), we obtain

$$\begin{aligned} &\int \left( \frac{\partial w^P}{\partial a_2}(y|a_1^P, a_2^P) - \lambda u'(\frac{\partial w^P}{\partial a_2}(y|a_1^P, a_2^P)) \right) f(y|a_1^P, a_2^P) dy \\ &= \mu_1(a_1^P, a_2^P) \int \frac{\partial w^P}{\partial a_2}(y|a_1^P, a_2^P) f_1(y|a_1^P, a_2^P) u'(\frac{\partial w^P}{\partial a_2}(y|a_1^P, a_2^P)) dy. \end{aligned} \quad (\text{A4})$$

When  $w^P(y|a_1^P, a_2)$  is designed for  $\forall a_2$ , it should satisfy the such incentive constraint (where  $w^P(y|a_1^P, a_2 = a_2^P) \equiv w^P(y|a_1^P, a_2^P)$ ) as

$$\int u(w^P(y|a_1^P, a_2)) f_1(y|a_1^P, a_2) dy = v'(a_1^P). \quad (\text{A5})$$

---

<sup>1</sup>The second equality below holds even in the region where the limited liability constraint binds and  $w^P(y|a_1^P, a_2^P) = k$  as its derivative with respect to  $a_2$  is 0, except on measure 0. A small change in  $a_2$  leads to only a small change in the region of a binding limited liability.

We get the following by differentiating both side of equation (A5) by  $a_2$  at  $a_2 = a_2^P$ :

$$\int u'(w^P(y|a_1^P, a_2^P)) \frac{\partial w^P}{\partial a_2}(y|a_1^P, a_2^P) f_1(y|a_1^P, a_2^P) dy = - \int u(w^P(y|a_1^P, a_2^P)) f_{12}(y|a_1^P, a_2^P) dy. \quad (A6)$$

Plugging equation (A6) into equation (A2), we get the following equation (10).<sup>2</sup>

$$\begin{aligned} \phi_2(a_1^P, a_2^P) &= \int y f_2(y|a_1^P, a_2^P) dy = \int \left( w^P(y|a_1^P, a_2^P) - \lambda u(w^P(y|a_1^P, a_2^P)) \right) f_2(y|a_1^P, a_2^P) dy \\ &\quad - \mu_1(a_1^P, a_2^P) \int u(w^P(y|a_1^P, a_2^P)) f_{12}(y|a_1^P, a_2^P) dy. \end{aligned} \quad (A9)$$

■

**Proof of Proposition 1:** Assume to the contrary that  $\mu_1^* \phi_1^* + \mu_2^* \phi_2^* \leq 0$ . Then, pick up any two levels of  $y$ :  $y_1$  and  $y_2$ , such that

$$y_1 < y_2, \text{ and } \frac{y_1 + y_2}{2} = \phi(a_1^*, a_2^*). \quad (A10)$$

That is,  $y_1$  and  $y_2$  are located at the same distance from the mean value  $\phi(a_1^*, a_2^*)$ . If  $\mu_1^* \phi_1^* + \mu_2^* \phi_2^* \leq 0$ , we have from equation (18) that

$$w^*(y_1) \geq w^*(y_2), \text{ and } u(w^*(y_1)) \geq u(w^*(y_2)). \quad (A11)$$

Since  $f_1(y_1|a_1^*, a_2^*) = -f_1(y_2|a_1^*, a_2^*) < 0$  for any  $y_1$  and  $y_2$  satisfying equation (A10), we have:

$$\int u(w^*(y)) f_1(y|a_1^*, a_2^*) dy \leq 0, \text{ and } \int u(w^*(y)) f_1(y|a_1^*, a_2^*) dy - v'(a_1^*) < 0. \quad (A12)$$

Therefore, there is a contradiction.

■

**Proof of Proposition 2:**

<sup>2</sup>We can derive it using the envelope theorem. We regard the principal's optimization as the one in which given a fixed  $a_2$ , we find optimal  $a_1, w(\cdot)$  that maximizes joint utility of the principal and agent under the incentive constraint for  $a_1$  and limited liability constraint. A principal solves the following optimization.

$$\begin{aligned} SW(a_2) &= \min_{\mu_1} \max_{w(\cdot), a_1} L(a_2) \equiv \phi(a_1, a_2) - \int w(y) f(y|a_1, a_2) dy + \lambda \left( \int u(w(y)) f(y|a_1, a_2) dy - v(a_1) \right) \\ &\quad + \mu_1 \left( \int u(w(y)) f_1(y|a_1, a_2) dy - v'(a_1) \right) \end{aligned} \quad (A7)$$

As  $(a_1^P, w^P(\cdot|a_1^P, a_2^P))$  are the solution given  $a_2^P$ ,  $SW'(a_2^P) = 0$  must hold, which turns out to be the same as equation (10). Thus an envelope theorem yields equation (10), where  $\mu_1(a_1^P, a_2^P)$  are the endogenous Lagrange multiplier for incentive constraint for  $a_1$  at  $a_1^P$  given  $a_2^P$ . Thus, we obtain

$$SW'(a_2^P) = \int \left( y - w^P(y) + \lambda u(w^P(y)) \right) f_2(y|a_1^P, a_2^P) dy + \mu_1(a_1^P, a_2^P) \int u(w^P(y)) f_{12}(y|a_1^P, a_2^P) dy = 0. \quad (A8)$$

(Case 1)  $\mu_2^* > 0$  if  $a_2^A(a_2^P) < a_2^P$ : Compare the following two optimizations:<sup>3</sup>

$$\begin{aligned} & \max_{a_1, a_2, w(\cdot)} \int (y - w(y))f(y|a_1, a_2)dy + \lambda \left( \int u(w(y))f(y|a_1, a_2)dy - v(a_1) \right) \quad \text{s.t.} \\ & (i) \quad \int u(w(y))f_1(y|a_1, a_2)dy - v'(a_1) = 0, \\ & (ii) \quad \int u(w(y))f_2(y|a_1, a_2)dy = 0, \\ & (iii) \quad w(y) \geq k, \quad \forall y, \end{aligned} \tag{A13}$$

and

$$\begin{aligned} & \max_{a_1, a_2, w(\cdot)} \int (y - w(y))f(y|a_1, a_2)dy + \lambda \left( \int u(w(y))f(y|a_1, a_2)dy - v(a_1) \right) \quad \text{s.t.} \\ & (i) \quad \int u(w(y))f_1(y|a_1, a_2)dy - v'(a_1) = 0, \\ & (ii) \quad \int u(w(y))f_2(y|a_1, a_2)dy \geq 0, \\ & (iii) \quad w(y) \geq k, \quad \forall y, \end{aligned} \tag{A14}$$

where the incentive constraint associated with the non-hedgeable risk choice  $a_2$  takes the form of inequality in the latter program, instead of equality in the original optimization program.

We know  $(w^*(y), a_1^*, a_2^*, \mu_1^*, \mu_2^*)$  are the optimal solution for the first program. Let  $(\hat{w}(y), \hat{a}_1, \hat{a}_2, \hat{\mu}_1, \hat{\mu}_2)$  be the optimal solution for the second program. We will show that the above two programs are equivalent in that two solutions align perfectly with each other when  $a_2^A(a_2^P) < a_2^P$ . Then, we can directly derive  $\mu_2^* \geq 0$  when  $a_2^A(a_2^P) < a_2^P$ , since  $\hat{\mu}_2 \geq 0$  by Kuhn-Tucker theorem.

Assume that the second constraint in the second program is not binding. Then,  $\hat{\mu}_2 = 0$ , and  $\hat{w}(y)$  should satisfy:

$$\frac{1}{u'(\hat{w}(y))} = \lambda + \hat{\mu}_1 \frac{y - \phi(\hat{a}_1, \hat{a}_2)}{(\hat{a}_2)^2} \phi_1(\hat{a}_1, \hat{a}_2), \tag{A15}$$

for  $y$  satisfying  $\hat{w}(y) \geq k$  and  $\hat{w}(y) = k$  otherwise. As we know that the second constraint is not binding,  $\hat{a}_2$  becomes the best (from the principal's perspective)  $a_2$ , i.e.,  $\hat{a}_2 = a_2^P$ . Then we must have  $\hat{a}_1 = a_1^P$  and  $\hat{w}(y) = w^P(y|a_1^P, a_2^P)$ . Therefore, the fact that the second constraint in the second program is not binding implies

$$\int u(w^P(y|a_1^P, a_2^P))f_2(y|a_1^P, a_2^P, a_3 = 0)dy > 0. \tag{A16}$$

However, equation (A16) implies  $a_2^A(a_2^P) > a_2^P$ , which is a contradiction.<sup>4</sup> Thus, the second constraint in the second program must be binding, and the above two programs are equivalent so  $\mu_2^* = \hat{\mu}_2 \geq 0$ . And also,  $\mu_2^* \neq 0$ , because  $\mu_2^* = 0$  implies  $a_2^A(a_2^P) = a_2^P$ .

<sup>3</sup>Following [Rogerson \(1985\)](#), we replace the incentive constraint with the corresponding inequality constraint, and exploit the fact that a multiplier to the inequality constraint must be non-negative.

<sup>4</sup>We assume that  $\int u(w(y|a_2^P))f(y|a_1^P, a_2, a_3 = 0)dy$  is concave in  $a_2$ , which is based on the first-order approach associated with  $a_2$ .

(Case 2)  $\mu_2^* < 0$  if  $a_2^A(a_2^P) > a_2^P$ : This proof easily follows by using the same method in (Case 1).<sup>5</sup>

■

**Proof of Proposition 3:** Consider the principal's maximization program such as:<sup>6</sup>

$$\begin{aligned}
& \max_{a_1(\cdot), a_2(\cdot), w(\cdot)} \int_R \int_{x, \eta} (x - w(x, R, \eta)) g(x, \eta | a_1(R), a_2(R), R) h(R) dx d\eta dR \\
& \quad + \lambda \int_R \left( \int_{x, \eta} u(w(x, R, \eta)) g(x, \eta | a_1(R), a_2(R), R) dx d\eta - v(a_1(R)) \right) h(R) dR \quad \text{s.t.} \\
& (i) \quad \int_{x, \eta} u(w(x, R, \eta)) g_1(x, \eta | a_1(R), a_2(R), R) dx d\eta - v'(a_1(R)) = 0, \forall R, \\
& (ii) \quad \int_{x, \eta} u(w(x, R, \eta)) g_2(x, \eta | a_1(R), a_2(R), R) dx d\eta = 0, \forall R, \\
& (iii) \quad w(x, R, \eta) \geq k, \quad \forall (x, \eta).
\end{aligned} \tag{A20}$$

Note the above program is different from the original program (21) in that here contract can be written on the realized value of  $R$ . If we let Lagrange multipliers to the constraints (i) and (ii) be  $\mu_1(R)h(R)$  and

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<sup>5</sup>We compare following two optimization programs similar to equation (A13) and equation (A14).

$$\begin{aligned}
& \max_{a_1, a_2, w(\cdot)} \int (y - w(y)) f(y | a_1, a_2) dy + \lambda \left( \int u(w(y)) f(y | a_1, a_2) dy - v(a_1) \right) \quad \text{s.t.} \\
& (i) \quad \int u(w(y)) f_1(y | a_1, a_2) dy - v'(a_1) = 0, \\
& (ii) \quad \int u(w(y)) f_2(y | a_1, a_2) dy = 0, \\
& (iii) \quad w(y) \geq k, \quad \forall y,
\end{aligned} \tag{A17}$$

and

$$\begin{aligned}
& \max_{a_1, a_2, w(\cdot)} \int (y - w(y)) f(y | a_1, a_2) dy + \lambda \left( \int u(w(y)) f(y | a_1, a_2) dy - v(a_1) \right) \quad \text{s.t.} \\
& (i) \quad \int u(w(y)) f_1(y | a_1, a_2) dy - v'(a_1) = 0, \\
& (ii) \quad \int u(w(y)) f_2(y | a_1, a_2) dy \leq 0, \\
& (iii) \quad w(y) \geq k, \quad \forall y,
\end{aligned} \tag{A18}$$

Solutions of two optimization programs must be the same, and due to the property that the multiplier attached to the incentive constraint associated with  $a_2$  in the second program must be non-positive, we conclude  $\mu_2^* < 0$  when  $a_2^A(a_2^P) > a_2^P$ .

<sup>6</sup> $g(x, \eta | a_1, a_2, R)$  yields the following likelihood ratios:

$$\begin{aligned}
\frac{g_1}{g}(x, \eta | a_1, a_2, R) &= \frac{x - R\eta - \phi(a_1, a_2)}{a_2^2} \phi_1(a_1, a_2), \quad \frac{g_3}{g}(x, \eta | a_1, a_2, R) = \frac{(x - R\eta - \phi(a_1, a_2))\eta}{a_2^2}, \\
\frac{g_2}{g}(x, \eta | a_1, a_2, R) &= -\frac{1}{a_2} + \frac{x - R\eta - \phi(a_1, a_2)}{a_2^2} \phi_2(a_1, a_2) + \frac{(x - R\eta - \phi(a_1, a_2))^2}{a_2^3}.
\end{aligned} \tag{A19}$$



$\mu_2(R)h(R)$  respectively, we get the following optimal contractual form:<sup>7</sup>

$$\begin{aligned} \frac{1}{u'(w(x, R, \eta))} &= \lambda + \mu_1(R) \frac{x - R\eta - \phi_R}{a_2(R)^2} \phi_{1,R} + \mu_2(R) \left[ -\frac{1}{a_2(R)} + \frac{x - R\eta - \phi_R}{a_2(R)^2} \phi_{2,R} + \frac{(x - R\eta - \phi_R)^2}{a_2(R)^3} \right] \\ &= \lambda + (\mu_1(R)\phi_{1,R} + \mu_2(R)\phi_{2,R}) \frac{\underbrace{x - R\eta - \phi_R}_{\equiv y}}{a_2(R)^2} + \frac{\mu_2(R)}{a_2(R)} \left[ \frac{\underbrace{(x - R\eta - \phi_R)^2}_{\equiv y}}{a_2(R)^2} - 1 \right], \end{aligned} \quad (\text{A21})$$

when  $w(x, R, \eta) \geq k$ . The above equation (A21) implies that optimal contract only depends on  $y \equiv x - R\eta$  and the solution  $(w(x, R, \eta), a_1(R), a_2(R))$  becomes  $(a_1^*, a_2^*, w^*(y) \equiv w^*(x - R\eta))$ . By comparing the above equation (A20) with the program in equation (21) when he does not know  $R$ , one can easily see that the set of wage contracts,  $\{w(x, R, \eta)\}$ , satisfying the incentive constraints for a given action combination  $(a_1(R), a_2(R))$  in the above program always contains the set of wage contracts that would be available when the principal does not know  $R$ ,  $\{w(x, \eta)\}$ , satisfying the incentive constraints for the same action combination. Therefore, we have

$$SW^N \leq SW^*(a_1^*, a_2^*). \quad (\text{A22})$$

However, one can easily see that  $w^*(y) = w^*(x - R\eta)$  which is a unique solution for the wage contract of the above program is not in the set of  $\{w(x, \eta)\}$ . As a result, we finally derive

$$SW^N < SW^*(a_1^*, a_2^*). \quad (\text{A23})$$

### Proof of Lemma 2:

(1) Suppose  $\mu_2^* < 0$  in equation (27) for any given  $\hat{b}$ . Proposition 2 implies that if the shareholders want their manager to reduce the risk through the project choice (i.e., if  $a_2^P < a_2^A(a_2^P)$ ), the optimal contract in equation (18) features  $\mu_2^* < 0$ . Note that risk reduction through the real project choice (i.e., lowering  $a_2$ ) is costly to the manager in the sense that a less risky project generates the lower expected return, and thereby reduces the agent's expected payoff (i.e.,  $\mu_1^* \phi_1^* + \mu_2^* \phi_2^* > 0$ ). Thus, the fact that even costly risk reduction is encouraged by  $w^*(z(\hat{b}))$  implies that any risk reduction (i.e., reducing the variance of  $z(\hat{b})$ ) in the absence of expected return reduction will be taken by the manager under  $w^*(z(\hat{b}))$ . Risk reduction through derivative transaction is costless to the agent because there is no risk-return trade-off for derivative transaction (i.e., manipulating  $a_3$ ). Whenever taking further risk reduction is encouraged, therefore, the manager would like to do it through the derivative choices first.

Thus, the manager will choose  $a_3$  so that  $b \equiv R - a_3 = \hat{b}$  which minimizes the variance of  $z(\hat{b})$ , when  $w^*(z(\hat{b}))$  with  $\mu_2^* < 0$  is designed.

■

(2) Suppose  $\mu_2^* > 0$  for  $w^*(z(\hat{b}))$  in equation (27). Given  $(a_1^*, a_2^*)$ ,  $z(\hat{b}) = x - \hat{b}\eta = \phi(a_1^*, a_2^*) + (b - \hat{b})\eta + a_2^*\theta$

<sup>7</sup>We define  $\phi_R \equiv \phi(a_1(R), a_2(R))$ ,  $\phi_{i,R} \equiv \phi_i(a_1(R), a_2(R))$  for  $\forall i = 1, 2$ , where  $\{a_1(R), a_2(R)\}$  are optimal actions for each  $R$ .

holds. With the normalized output  $\tilde{x} \equiv \frac{z(\hat{b}) - \phi(a_1^*, a_2^*)}{a_2^*} = \frac{b - \hat{b}}{a_2^*} \eta + \theta$ , which follows the normal distribution, as  $\eta$  and  $\theta$  both follow the standard normal and are independent, (27) becomes:

$$\begin{aligned} \frac{1}{u'(w^*(z(\hat{b})))} &= \lambda + (\mu_1^* \phi_1^* + \mu_2^* \phi_2^*) \frac{z(\hat{b}) - \phi(a_1^*, a_2^*)}{(a_2^*)^2} + \mu_2^* \frac{1}{a_2^*} \left( \frac{(z(\hat{b}) - \phi(a_1^*, a_2^*))^2}{(a_2^*)^2} - 1 \right) \\ &= \lambda - \underbrace{\frac{\mu_2^*}{a_2^*}}_{\equiv \kappa_0 \leq 0} + \underbrace{\frac{\mu_1^* \phi_1^* + \mu_2^* \phi_2^*}{a_2^*}}_{\equiv \kappa_1 > 0} \tilde{x} + \underbrace{\frac{\mu_2^*}{a_2^*}}_{\equiv \kappa_2 > 0} \tilde{x}^2 = \kappa_0 + \kappa_1 \tilde{x} + \kappa_2 \tilde{x}^2, \end{aligned} \quad (\text{A24})$$

when  $\kappa_0 + \kappa_1 \tilde{x} + \kappa_2 \tilde{x}^2 \geq \frac{1}{u'(k)}$ . Otherwise  $w^*(z(\hat{b})) = k$ . Let  $p \equiv \frac{1}{u'(k)} > 0$ ,  $\rho(z) \equiv u((u')^{-1}(\frac{1}{z}))$ ,  $\forall z$ , and  $\hat{\rho}(\tilde{x}) \equiv \rho(\max\{p, \kappa_0 + \kappa_1 \tilde{x} + \kappa_2 \tilde{x}^2\})$ . Then,  $\hat{\rho}(\tilde{x}) = u(w^*(z(\hat{b})))$  is the agent's indirect utility given  $\tilde{x}$ . Since  $\kappa_2 > 0$ ,  $\kappa_0 + \kappa_1 \tilde{x} + \kappa_2 \tilde{x}^2$  yields a minimum at  $\tilde{x}_c = -\frac{\kappa_1}{2\kappa_2} < 0$ . If a limited liability does not bind at a point, i.e.,  $\kappa_0 + \kappa_1 \tilde{x} + \kappa_2 \tilde{x}^2 > p^8$ , then  $\hat{\rho}'(\tilde{x}) = \rho'(\kappa_0 + \kappa_1 \tilde{x} + \kappa_2 \tilde{x}^2) \cdot (\kappa_1 + 2\kappa_2 \tilde{x})$ . Since  $\rho(\cdot)$  is increasing, we know that  $\hat{\rho}(\cdot)$  is symmetric around  $\tilde{x}_c$  and satisfies  $\hat{\rho}'(\tilde{x}) \rightarrow \infty$  as  $\tilde{x} \rightarrow \infty$  and  $\hat{\rho}'(\tilde{x}) \rightarrow -\infty$  as  $\tilde{x} \rightarrow -\infty$ . In this case the agent chooses  $b = \pm\infty$  (or  $a_3 = \pm\infty$ ).

**Why?** Let  $w(\eta, \theta, b|w^*)$  be the wage that the manager will receive under  $w^*(z(\hat{b}))$  when he takes  $(a_1^*, a_2^*, b)$  and  $(\eta, \theta)$  are realized. Then, by substituting equation (25) into equation (27), we have

$$\frac{1}{u'(w(\eta, \theta, b|w^*))} = \lambda + (\mu_1^* \phi_1^* + \mu_2^* \phi_2^*) \frac{(b - \hat{b})\eta + a_2^* \theta}{(a_2^*)^2} + \mu_2^* \frac{1}{a_2^*} \left( \frac{((b - \hat{b})\eta + a_2^* \theta)^2}{(a_2^*)^2} - 1 \right). \quad (\text{A25})$$

Therefore, for two different  $b$ , say  $b^0$  and  $b^1$ , given the realized  $(\eta, \theta)$ , we have

$$\begin{aligned} \frac{1}{u'(w(\eta, \theta, b^1|w^*))} - \frac{1}{u'(w(\eta, \theta, b^0|w^*))} &= (\mu_1^* \phi_1^* + \mu_2^* \phi_2^*) \frac{(b^1 - b^0)\eta}{(a_2^*)^2} \\ &\quad + \mu_2^* \frac{1}{a_2^*} \left( \frac{((b^1 - \hat{b})\eta + a_2^* \theta)^2 - ((b^0 - \hat{b})\eta + a_2^* \theta)^2}{(a_2^*)^2} \right). \end{aligned} \quad (\text{A26})$$

Assume that  $b^1 = +\infty$  or  $-\infty$ , and  $-\infty < b^0 < +\infty$ . Since  $\mu_2^* > 0$ , we have from the above that

$$\frac{1}{u'(w(\eta, \theta, b^1|w^*))} - \frac{1}{u'(w(\eta, \theta, b^0|w^*))} > 0, \quad \forall (\eta, \theta). \quad (\text{A27})$$

Therefore, we have

$$w(\eta, \theta, b^1|w^*) > w(\eta, \theta, b^0|w^*), \quad \forall (\eta, \theta). \quad (\text{A28})$$

which implies that the agent will actually take  $a_3$  satisfying  $b = +\infty$  or  $-\infty$  when  $w^*(z(\hat{b}))$  with  $\mu_2^* > 0$  is designed. ■

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<sup>8</sup>We defined  $p \equiv \frac{1}{u'(k)} > 0$  before, where  $k$  is the minimum subsistence level of the compensation.

**Proof of Lemma 3:** From equation (25), we have  $z(\hat{b}) = \phi(a_1, a_2) + (b - \hat{b})\eta + a_2\theta$  for any given  $(a_1, a_2, b)$ , and  $z(0) = \phi(a_1, a_2) + b'\eta + a_2\theta$  for any given  $(a_1, a_2, b')$ . Therefore, we obtain

$$z(\hat{b}|a_1, a_2, b) = z(0|a_1, a_2, b'), \text{ whenever } b' = b - \hat{b}. \quad (\text{A29})$$

Furthermore, if  $b' = b - \hat{b}$ , two joint density functions of  $(z(\hat{b}), \eta)$  and  $(z(0), \eta)$  are the same, i.e.,

$$\begin{aligned} g(z(\hat{b}), \eta|a_1, a_2, b) &= \frac{1}{2\pi a_2} \exp \left( -\frac{1}{2} \left( \frac{(z(\hat{b}) - \phi(a_1, a_2) - (b - \hat{b})\eta)^2}{a_2^2} + \eta^2 \right) \right) \\ &= g(z(0), \eta|a_1, a_2, b'), \quad \forall b' = b - \hat{b}. \end{aligned} \quad (\text{A30})$$

Thus, we derive that for  $\forall(a_1, a_2, b)$ , we have

$$\int u(w^o(z(\hat{b}), \eta))g(z(\hat{b}), \eta|a_1, a_2, b)dzd\eta = \int u(w^o(z(0), \eta))g(z(0), \eta|a_1, a_2, b' = b - \hat{b})dzd\eta. \quad (\text{A31})$$

Note that the manager is induced to take  $(a_1^o, a_2^o, b^o \equiv R - a_3^o = \hat{b})$  under the contract  $w^o(z(\hat{b}), \eta)$ . Thus, the manager will be induced to take  $(a_1^o, a_2^o, b' = 0 \text{ (i.e., } a_3 = R))$  under wage contract  $w^o(z(0), \eta)$ . Moreover, since

$$\int w^o(z(\hat{b}), \eta)g(z(\hat{b}), \eta|a_1^o, a_2^o, b^o)dzd\eta = \int w^o(z(0), \eta)g(z(0), \eta|a_1^o, a_2^o, 0)dzd\eta, \quad (\text{A32})$$

using equation (28) and equation (29), we finally derive:

$$SW^o(a_1^o, a_2^o, a_3^o) = SW^o(a_1^o, a_2^o, R).$$

■

**Proof of Lemma 4:** When  $w^*(z(0))$  described in equation (27) is designed, we have

$$z(0|a_1, a_2, b) = x = \phi(a_1, a_2) + b\eta + a_2\theta. \quad (\text{A33})$$

If the agent takes  $(a_1, a_2, b)$  under  $w^*(z(0))$ , then his expected utility is:

$$\int u(w^*(z(0)))g(z(0), \eta|a_1, a_2, b)dzd\eta - v(a_1) = \int u(w^*(z(0)))q(z(0)|a_1, a_2, b, \eta)l(\eta)dzd\eta - v(a_1), \quad (\text{A34})$$

where  $q(\cdot)$  denotes the conditional density function of  $z(0)$  given  $(a_1, a_2, b, \eta)$  and  $l(\cdot)$  denotes the density function of  $\eta \sim N(0, 1)$ .

Now, suppose the agent takes  $(a_1, a_2, -b)$  under  $w^*(z(0))$ . Then, his expected utility becomes:

$$\int u(w^*(z(0)))g(z(0), \eta|a_1, a_2, -b)dzd\eta - v(a_1) = \int u(w^*(z(0)))q(z(0)|a_1, a_2, -b, \eta)l(\eta)dzd\eta - v(a_1). \quad (\text{A35})$$

Since

$$q(z(0)|a_1, a_2, b, \eta) = \frac{1}{\sqrt{2\pi}a_2} \exp\left(-\frac{(z(0) - \phi(a_1, a_2) - b\eta)^2}{2a_2^2}\right), \quad (\text{A36})$$

we have

$$q(z(0)|a_1, a_2, b, \eta) = q(z(0)|a_1, a_2, -b, -\eta). \quad (\text{A37})$$

Since  $\eta \sim N(0, 1)$  is symmetrically distributed around 0 and  $l(\eta) = l(-\eta)$ ,  $\forall \eta$ , we finally have

$$\int u(w^*(z(0)))g(z(0), \eta|a_1, a_2, b)dzd\eta - v(a_1) = \int u(w^*(z(0)))g(z(0), \eta|a_1, a_2, -b)dzd\eta - v(a_1). \quad (\text{A38})$$

■

**Proof of Proposition 5:** To prove this proposition, we start with the following lemma.

**Lemma A1:** If  $\mu_2^* > 0$  for contract  $w^*(z(0))$  in equation (27), then the optimal contract  $w^o(x, \eta)$  guaranteeing that the agent takes  $a_1^o, a_2^o, a_3^o = R$ , i.e.,  $w^o(x, \eta)$  in equation (37), must satisfy

$$(1) \mu_2^o \geq 0$$

$$(2) \mu_4^o(b) \neq 0 (> 0) \text{ for a positive Borel-measure of } b.^9$$

$$(3) \mu_4^o(b) = \mu_4^o(-b) \text{ for all } b \text{ and } w^o(x, \eta) = w^o(x, -\eta) \text{ for all } x, \eta$$

**Proof of Lemma A1:**

(1)  $\mu_2^o \geq 0$ : Assume that  $\mu_2^o < 0$ , then under the contract  $w^1(x, \eta)$  satisfying

$$\frac{1}{u'(w^1(x, \eta))} = \lambda + (\mu_1^o\phi_1^o + \mu_2^o\phi_2^o) \frac{x - \phi(a_1^o, a_2^o)}{(a_2^o)^2} + \frac{\mu_2^o}{a_2^o} \left( \frac{(x - \phi(a_1^o, a_2^o))^2}{(a_2^o)^2} - 1 \right), \quad (\text{A39})$$

for  $(x, \eta)$  satisfying  $w^1(x, \eta) \geq k$  and  $w^1(x, \eta) = k$ , the agent voluntarily chooses  $b = 0$  even though we did not consider the constraint (iii) in (36). Thus  $w^1(x, \eta)$  becomes the solution of (36). However, it contradicts with our assumption of  $\mu_2^* > 0$  for  $w^*(z(0))$  since  $(w^1(x, \eta), \mu_1^o, \mu_2^o)$  becomes  $(w^*(z(0)), \mu_1^*, \mu_2^*)$  without the incentive constraint (iii) about  $b$ .

(2)  $\mu_4^o(b) \neq 0$  for a positive Borel-measure of  $b$ : Assume  $\mu_4^o(b) = 0$  a.s. Then optimal contract  $w^o(x, \eta)$  becomes:

$$\frac{1}{u'(w^o(x, \eta))} = \lambda + (\mu_1^o\phi_1^o + \mu_2^o\phi_2^o) \frac{x - \phi(a_1^o, a_2^o)}{(a_2^o)^2} + \frac{\mu_2^o}{a_2^o} \left( \frac{(x - \phi(a_1^o, a_2^o))^2}{(a_2^o)^2} - 1 \right), \quad (\text{A40})$$

for  $(x, \eta)$  satisfying  $w^o(x, \eta) \geq k$  and  $w^o(x, \eta) = k$ .

---

<sup>9</sup>We already know  $\mu_4^o(b) \geq 0$  for every  $b$  (almost surely), since it is derived from the inequality constraint at each  $b$ .

Because we already know  $(w^o(x, \eta), \mu_1^o, \mu_2^o)$  becomes  $(w^*(z(0)), \mu_1^*, \mu_2^*)$  in this case and  $\mu_2^* > 0$  holds,  $(w^o(x, \eta), \mu_1^o, \mu_2^o)$  will induce  $b = \pm\infty$  instead of  $b = 0$  from the agent, a contradiction to the constraint (iii) in (36).

(3)  $\mu_4^o(b) = \mu_4^o(-b)$  for all  $b$  and  $w^o(x, \eta) = w^o(x, -\eta)$  for all  $x, \eta$ : We first see:

$$g(x, \eta|b) = \frac{1}{2\pi a_2^o} \exp \left( -\frac{1}{2} \frac{(x - \phi(a_1^o, a_2^o) - b\eta)^2}{(a_2^o)^2} - \frac{1}{2} \eta^2 \right), \quad (\text{A41})$$

where

$$\frac{g(x, \eta|b)}{g(x, \eta|b=0)} = \exp \left( \frac{b\eta(x - \phi(a_1^o, a_2^o))}{(a_2^o)^2} \right) \exp \left( -\frac{b^2\eta^2}{2(a_2^o)^2} \right). \quad (\text{A42})$$

Our strategy is to prove: the optimal contract  $w^o(x, \eta)$  with  $\mu_4^o(b) = \mu_4^o(-b)$  for  $\forall b$  from (37) satisfies the complementary slackness condition of  $\forall b$ , which by Kuhn and Tucker (1951) guarantees both necessity and sufficiency of the solution.<sup>10</sup> To that end, (i) given  $\mu_4^o(b) = \mu_4^o(-b)$ , we prove  $w^o(x, \eta) = w^o(x, -\eta)$  for  $\forall x, \eta$ ; (ii) then we show that the solution with  $\mu_4^o(b) = \mu_4^o(-b)$  and that satisfies  $w^o(x, \eta) = w^o(x, -\eta)$  for  $\forall x, \eta$  satisfies the complementarity slackness condition about  $b$ .

**Step 1.**  $\mu_4^o(b) = \mu_4^o(-b)$  implies  $w^o(x, \eta) = w^o(x, -\eta)$  for all  $x, \eta$  in (37).

For a while let us assume  $\mu_4^o(b) = \mu_4^o(-b)$  holds. To show  $w^o(x, \eta) = w^o(x, -\eta)$  for  $\forall x, \eta$ , equation (37) and equation (A42) implies it suffices to prove:

$$\begin{aligned} & \int \mu_4^o(b) \exp \left( \frac{b\eta(x - \phi(a_1^o, a_2^o))}{(a_2^o)^2} \right) \exp \left( -\frac{b^2\eta^2}{2(a_2^o)^2} \right) db \\ &= \int \mu_4^o(b) \exp \left( \frac{b(-\eta)(x - \phi(a_1^o, a_2^o))}{(a_2^o)^2} \right) \exp \left( -\frac{b^2\eta^2}{2(a_2^o)^2} \right) db. \end{aligned} \quad (\text{A43})$$

Using our assumed multiplier symmetry  $\mu_4^o(b) = \mu_4^o(-b)$ , we have:

$$\begin{aligned} & \int \mu_4^o(b) \exp \left( \frac{b(-\eta)(x - \phi(a_1^o, a_2^o))}{(a_2^o)^2} \right) \exp \left( -\frac{b^2\eta^2}{2(a_2^o)^2} \right) db \\ & \stackrel{\text{under } b \rightarrow -b}{=} \int \mu_4^o(-\tilde{b}) \exp \left( \frac{\tilde{b}\eta(x - \phi(a_1^o, a_2^o))}{(a_2^o)^2} \right) \exp \left( -\frac{\tilde{b}^2\eta^2}{2(a_2^o)^2} \right) d\tilde{b} \\ & \stackrel{\text{under } \tilde{b} \rightarrow b}{=} \int \mu_4^o(\tilde{b}) \exp \left( \frac{\tilde{b}\eta(x - \phi(a_1^o, a_2^o))}{(a_2^o)^2} \right) \exp \left( -\frac{\tilde{b}^2\eta^2}{2(a_2^o)^2} \right) d\tilde{b}. \end{aligned} \quad (\text{A44})$$

Thus we have  $w^o(x, \eta) = w^o(x, -\eta)$  for any  $x, \eta$  if  $\mu_4^o(b) = \mu_4^o(-b)$  for  $\forall b$ .

<sup>10</sup>See Luenberger (1969) for a comprehensive treatment of this issue.

**Step 2.** Next, we show that this solution satisfies the complementary slackness conditions.<sup>11</sup>

For an arbitrary  $b_1$  such that  $\mu_4^o(b_1) > 0$ , we have:

$$0 = \int u(w^o(x, \eta)) (g(x, \eta|b=0) - g(x, \eta|b_1)) dx d\eta, \quad (\text{A45})$$

where (A42) implies:

$$\begin{aligned} & g(x, \eta|b=0) - g(x, \eta|b_1) \\ &= \frac{1}{2\pi a_2^o} \exp\left(-\frac{(x - \phi(a_1^o, a_2^o))^2}{2(a_2^o)^2} - \frac{\eta^2}{2}\right) \left(1 - \exp\left(\frac{b_1 \eta (x - \phi(a_1^o, a_2^o))}{(a_2^o)^2}\right) \exp\left(-\frac{b_1^2 \eta^2}{2(a_2^o)^2}\right)\right). \end{aligned} \quad (\text{A46})$$

For our purpose of justifying  $\mu_4^o(b) = \mu_4^o(-b)$  for  $\forall b$ , we prove that it does not violate the complementary slackness conditions. we must show that equation (A45) implies:

$$0 = \int u(w^o(x, \eta)) (g(x, \eta|b=0) - g(x, \eta|-b_1)) dx d\eta. \quad (\text{A47})$$

With the help of equation (A46), it is sufficient to prove:<sup>12</sup>

$$\begin{aligned} & \int u(w^o(x, \eta)) \exp\left(\frac{b_1 \eta (x - \phi(a_1^o, a_2^o))}{(a_2^o)^2}\right) \exp\left(-\frac{b_1^2 \eta^2}{2(a_2^o)^2}\right) \exp\left(-\frac{(x - \phi(a_1^o, a_2^o))^2}{2(a_2^o)^2} - \frac{\eta^2}{2}\right) dx d\eta \\ &= \int u(w^o(x, \eta)) \exp\left(\frac{-b_1 \eta (x - \phi(a_1^o, a_2^o))}{(a_2^o)^2}\right) \exp\left(-\frac{b_1^2 \eta^2}{2(a_2^o)^2}\right) \exp\left(-\frac{(x - \phi(a_1^o, a_2^o))^2}{2(a_2^o)^2} - \frac{\eta^2}{2}\right) dx d\eta. \end{aligned} \quad (\text{A48})$$

Since  $w(x, \eta) = w(x, -\eta)$  for  $\forall x, \eta$  holds, we can easily prove equation (A48) by:

$$\begin{aligned} & \int u(w^o(x, \eta)) \exp\left(\frac{-b_1 \eta (x - \phi(a_1^o, a_2^o))}{(a_2^o)^2}\right) \exp\left(-\frac{b_1^2 \eta^2}{2(a_2^o)^2}\right) \exp\left(-\frac{(x - \phi(a_1^o, a_2^o))^2}{2(a_2^o)^2} - \frac{\eta^2}{2}\right) dx d\eta \\ & \underbrace{=}_{\tilde{\eta} \equiv -\eta} \int u(w^o(x, -\tilde{\eta})) \exp\left(\frac{b_1 \tilde{\eta} (x - \phi(a_1^o, a_2^o))}{(a_2^o)^2}\right) \exp\left(-\frac{b_1^2 \tilde{\eta}^2}{2(a_2^o)^2}\right) \exp\left(-\frac{(x - \phi(a_1^o, a_2^o))^2}{2(a_2^o)^2} - \frac{\tilde{\eta}^2}{2}\right) dx d\tilde{\eta} \\ & \underbrace{=}_{w(x, -\tilde{\eta}) = w(x, \tilde{\eta})} \int u(w^o(x, \tilde{\eta})) \exp\left(\frac{b_1 \tilde{\eta} (x - \phi(a_1^o, a_2^o))}{(a_2^o)^2}\right) \exp\left(-\frac{b_1^2 \tilde{\eta}^2}{2(a_2^o)^2}\right) \exp\left(-\frac{(x - \phi(a_1^o, a_2^o))^2}{2(a_2^o)^2} - \frac{\tilde{\eta}^2}{2}\right) dx d\tilde{\eta}. \end{aligned} \quad (\text{A49})$$

Thereby we effectively guarantee that  $w^o(x, \eta)$  with  $\mu_4^o(b) = \mu_4^o(-b)$  for  $\forall b$  is the optimal contract solving

<sup>11</sup>Step 2 constitutes the solution's sufficiency as (i) we characterized the first-order conditions with respect to  $a_1^o, a_2^o, w^o(x, \eta)$ , and (ii) our concave utility specification leads to the global Lagrangian's concavity condition in Kuhn and Tucker (1951).

<sup>12</sup>Thus our proof of equation (A48) actually proves that indirect utility of the agent is symmetric around  $b = 0$ .

the optimization (36), and satisfies  $w^o(x, \eta) = w^o(x, -\eta)$  for all  $x, \eta$ . ■

**Proof of Proposition 5:** Given  $(a_1^o, a_2^o)$ , we define  $\widehat{Cov} \equiv (x - \phi(a_1^o, a_2^o))\eta$ .<sup>13</sup> Since

$$\exp\left(\frac{b\eta(x - \phi(a_1^o, a_2^o))}{(a_2^o)^2}\right) = \exp\left(\frac{b}{(a_2^o)^2}\widehat{Cov}\right) = \sum_{k=0}^{\infty} \frac{1}{k!} \frac{b^k}{(a_2^o)^{2k}} \widehat{Cov}^k, \quad (\text{A50})$$

From (A42),

$$\frac{g(x, \eta|b)}{g(x, \eta|b=0)} = \left(\sum_{k=0}^{\infty} \frac{1}{k!} \frac{b^k}{(a_2^o)^{2k}} \widehat{Cov}^k\right) \exp\left(-\frac{b^2\eta^2}{2(a_2^o)^2}\right), \quad (\text{A51})$$

and therefore, we have:

$$\begin{aligned} \int \mu_4^o(b) \left(1 - \frac{g(x, \eta|b)}{g(x, \eta|b=0)}\right) db &= \int \mu_4^o(b) db - \int \mu_4^o(b) \left(\sum_{k=0}^{\infty} \frac{1}{k!} \frac{b^k}{(a_2^o)^{2k}} \widehat{Cov}^k\right) \exp\left(-\frac{b^2\eta^2}{2(a_2^o)^2}\right) db \\ &= \int \mu_4^o(b) db - \sum_{k=0}^{\infty} \left( \frac{1}{k!} \frac{1}{(a_2^o)^{2k}} \underbrace{\left(\int \mu_4^o(b) b^k \exp\left(-\frac{b^2\eta^2}{2(a_2^o)^2}\right) db\right)}_{\equiv C_k(\eta)} \right) \widehat{Cov}^k. \end{aligned} \quad (\text{A52})$$

When  $k$  is odd, the coefficient  $C_k(\eta)$  becomes 0 for  $\forall \eta$ , since  $\mu_4^o(b) = \mu_4^o(-b)$  for all  $b$  implies

$$C_{k:odd}(\eta) = \int \mu_4^o(b) b^k \exp\left(-\frac{b^2\eta^2}{2(a_2^o)^2}\right) db = \int_{b \geq 0} \underbrace{\left(\mu_4^o(b) - \mu_4^o(-b)\right)}_{=0} b^k \exp\left(-\frac{b^2\eta^2}{2(a_2^o)^2}\right) db = 0. \quad (\text{A53})$$

When  $k$  is even, the coefficient  $C_k(\eta)$  becomes strictly positive for  $\forall \eta$ , since  $\mu_4^o(b) \neq 0$  for the non-zero measure of  $b$  implies

$$\begin{aligned} C_{k:even}(\eta) &= \int \mu_4^o(b) b^k \exp\left(-\frac{b^2\eta^2}{2(a_2^o)^2}\right) db = \int_{b \geq 0} (\mu_4^o(b) + \mu_4^o(-b)) b^k \exp\left(-\frac{b^2\eta^2}{2(a_2^o)^2}\right) db \\ &= 2 \int_{b \geq 0} \mu_4^o(b) b^k \exp\left(-\frac{b^2\eta^2}{2(a_2^o)^2}\right) db > 0. \end{aligned} \quad (\text{A54})$$

Therefore, (A52) becomes:

$$\int \mu_4^o(b) \left(1 - \frac{g(x, \eta|b)}{g(x, \eta|b=0)}\right) db = \int \mu_4^o(b) db - 2 \sum_{k:even} \left( \frac{1}{k!} \frac{1}{(a_2^o)^{2k}} \left(\int_{b \geq 0} \mu_4^o(b) b^k \exp\left(-\frac{b^2\eta^2}{2(a_2^o)^2}\right) db\right) \right) \widehat{Cov}^k. \quad (\text{A55})$$

Finally, we can plug the expression (A55) into our optimal contact  $w^o(x, \eta)$  in (37) when  $w^o(x, \eta) \geq k$  and

<sup>13</sup>This is the value of sample covariance between  $x$  and  $\eta$ , as our framework is in single-period setting.

obtain

$$\begin{aligned}
\frac{1}{u'(w^o(x, \eta))} = & \lambda + (\mu_1^o \phi_1^o + \mu_2^o \phi_2^o) \frac{x - \phi(a_1^o, a_2^o)}{(a_2^o)^2} + \frac{\mu_2^o}{a_2^o} \left( \frac{(x - \phi(a_1^o, a_2^o))^2}{(a_2^o)^2} - 1 \right) + \underbrace{\int_{>0} \mu_4^o(b) db}_{>0} \\
& - 2 \underbrace{\sum_{k:\text{even}} \frac{1}{k!} \frac{1}{(a_2^o)^{2k}} \left( \underbrace{\int_{b \geq 0} \mu_4^o(b) b^k \exp\left(-\frac{b^2 \eta^2}{2(a_2^o)^2}\right) db}_{\equiv C_{k:\text{even}}(\eta) > 0} \right)}_{\equiv D_{k:\text{even}}(\eta) > 0} \widehat{Cov}^k.
\end{aligned} \tag{A56}$$

Since  $D_{k:\text{even}}(\eta) > 0$  for all even numbers  $k$ , given  $(x, \eta)$  a higher  $\widehat{Cov}$  results in a lower compensation  $w^o(x, \eta)$ . Also as  $D_{k:\text{even}}(\eta) > 0$  decreases in  $\eta^2$ , given  $(x, \widehat{Cov})$ , a higher  $\eta^2$  results in a higher  $w^o(x, \eta)$ . In sum the principal punishes a sample covariance  $|\widehat{Cov}|$  but becomes lenient when a high  $|\widehat{Cov}|$  comes from the high  $\eta$  realization, not from the agent's speculation activity ( $b \neq 0$ ).

**Note:** Let  $\rho(b) \equiv \int u(w^o(x, \eta)) g(x, \eta | a_1^o, a_2^o, b) dx d\eta - v(a_1^o)$  be the agent's expected indirect utility as a function of  $b$ . Then due to equation (A48) in (2) and (3) of Lemma A1,  $\rho(b) = \rho(0)$  holds for a positive measure of  $b$ <sup>14</sup> and  $\rho(b)$  must be symmetric around  $b = 0$ . Possible shapes of  $\rho(b)$  are provided in the following Figure F.1.

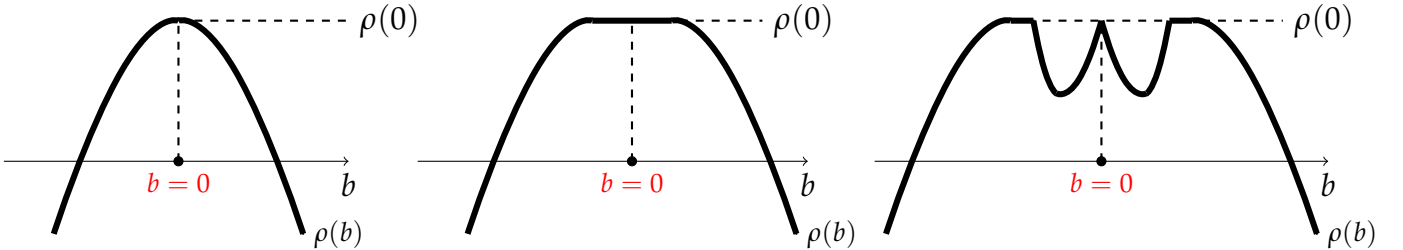


Figure F.1: Agent's Indirect Utility  $\rho(b)$  as a function of  $b$

As  $b \rightarrow \pm\infty$ ,  $\widehat{Cov} \rightarrow \pm\infty$  at any realization of  $(\theta, \eta)$  since  $\widehat{Cov} = b\eta^2 + a_2^o\theta\eta$  and  $\eta^2 > 0$ . The above argument implies: as  $b \rightarrow \pm\infty$ , we have  $w(x, \eta) = w(\phi(a_1^o, a_2^o) + b\eta + a_2^o\theta, \eta) < w(\phi(a_1^o, a_2^o) + a_2^o\theta, \eta)$  uniformly on  $(\theta, \eta)$ .<sup>15</sup> Thus we have  $\rho(b) < \rho(0)$  when  $b \rightarrow \pm\infty$ . ■

**Proof of Proposition 6:** Although we do not explicitly characterize  $SW^N$  in (23), we at least see  $SW^N$  is a continuous function of  $\sigma_R^2$ . On the other hand,  $w^*(y)$  characterized in (18) and  $w^o(x, \eta)$  in equation (37) are independent of  $\sigma_R^2$ , and so are  $SW^*(a_1^*, a_2^*)$  and  $SW^o(a_1^o, a_2^o, a_3^o = R)$ . Thus, as the amount of uncertainty on the firm's risk exposure approaches zero (i.e.,  $\sigma_R^2 \rightarrow 0$ ), we have

$$SW^*(a_1^*, a_2^*) - SW^N \rightarrow 0, \tag{A57}$$

<sup>14</sup>Due to the complementarity slackness condition about the constraint (iii) of the optimization in equation (36).

<sup>15</sup>Actually  $b \rightarrow \pm\infty$  also affects the output  $x$  in equation (A56). While terms up to a second-order of the output  $x$  enter in the optimal contract in equation (A56), higher order terms of  $\widehat{Cov}$  clearly dominates the first and second order terms of  $x$ .



since the reason  $SW^N < SW^*(a_1^*, a_2^*)$  is that the shareholders do not observe the realized  $R$  and this informational asymmetry disappears as  $\sigma_R^2 \rightarrow 0$ . As  $SW^*(a_1^*, a_2^*) - SW^o(a_1^o, a_2^o, R) > 0$  remains unchanged as  $\sigma_R^2 \rightarrow 0$ , when  $\sigma_R^2$  is very small, we have

$$SW^o(a_1^o, a_2^o, a_3^o = R) - SW^N < 0. \quad (\text{A58})$$

■

**Proof of Proposition 7:** From Lemma 5, we see that  $w^*(y_r)$  is a truth-telling mechanism for the firm's hidden risk exposure,  $R$ , if  $\mu_2^* < 0$  for  $w^*(y_r)$ . Since  $r = R, \forall R$ , under  $w^*(y_r)$ , we have

$$y \equiv x - R\eta = \phi(a_1, a_2) + a_2\theta = y_r. \quad (\text{A59})$$

Furthermore, we have that  $w^*(y_r)$  in equation (41) has the same contractual form as  $w^*(y)$  in (18). Thus, the optimal action combination to be chosen by the agent under  $w^*(y_r)$  is  $(a_1^*, a_2^*)$ , i.e.,  $(a_1^T(R), a_2^T(R)) = (a_1^*, a_2^*), \forall R$ . Therefore, we derive

$$SW^T = SW^*(a_1^*, a_2^*), \quad (\text{A60})$$

and from Proposition 4, we derive that  $SW^T$  is the same as the joint benefits that will be obtained under  $w^*(z(0))$  when there is a derivative market. ■

**Proof of Proposition 8** Note that both non-communication contracts  $w^N(x, \eta)$  and  $w^o(x, \eta)$  in (37) are truth-telling mechanisms.<sup>16</sup> Therefore, if  $\mu_2^* > 0$  for  $w^*(y_r)$  in equation (41), we have

$$SW^T \geq \max\{SW^N, SW^o(a_1^o, a_2^o, R)\}. \quad (\text{A61})$$

Furthermore, from Proposition 6, we have  $SW^N > SW^o(a_1^o, a_2^o, R)$  when  $\sigma_R^2$  is very small. Thus, we obtain that  $SW^T > SW^o(a_1^o, a_2^o, R)$  when  $\sigma_R^2$  is very small. ■

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<sup>16</sup>The principal can design  $w^N(x, \eta)$  without using  $r$ . Also, by designing  $w^o(y_r, \eta)$  as a truth-telling mechanism, he can obtain the same result as  $w^o(x, \eta)$  would provide.