Derivatives

Early Option Exercise: Never Say Never

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Working paper

A classic rule in financial economics states that, except just before expiration or dividend payments, one should never exercise a call option and never convert a convertible bond. This rule is ubiquitous in option theory and taught in most introductory finance classes.

This paper seeks to show that this rule breaks down — theoretically and empirically — when financial frictions are introduced, just as frictions break the Modigliani-Miller Theorem, the Law of One Price, and other classic rules in financial economics.

The authors contend that early exercise of options can be rational in light of financial frictions. They also assert that options exercises are more common when financial frictions are more severe. They also assert that it can be optimal to convert a convertible bond, especially among stocks with high short-sale costs.

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