Entrepreneurship, Compensation, and the Corporation

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This Essay revisits the concept of entrepreneurship, which is frequently neglected in mainstream economics, and discusses the importance of defining and isolating this concept in the context of the large, publicly-held business corporations. Almost by definition compensating for entrepreneurial services, ex ante or ex post, is problematic despite the availability of devices such as stock and stock options. It is argued that insider trading can serve as a unique compensation device and encourage a culture of innovation.

Much of the economics literature on the compensation of various personnel involved with the large, publicly-held business corporations has failed to come to grips explicitly with three important economic realities. The first is that there is no single model of corporate organization which will turn up valid answers for all occasions. The term "business corporation" should be broadened to include other corporation-like business associations, some of which have publicly-traded equity securities.[1] It is a many-splendored thing, ranging from the elemental, one-person corporation to the giant behemoth with millions of shareholders no one of whom has anything like a controlling influence on corporate affairs. In between these two lie every conceivable combination and permutation of ownership form and distribution, contractual (charters and by-laws included) provisions relating to managerial authority and to compensation, dividend policies, product market influences, organizational culture, norms, and applicable laws.

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[1] For a discussion of the importance of non-corporate forms and "uncorporation," see LARRY E. RIBSTEIN, THE RISE OF UNCORPORATION (forthcoming 2009); Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289 (2009); Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 U. ILL. L. REV. 131.

The second reality is that there are numerous economic functions involved in every corporation, although these intellectually distinguishable functions are rarely isolated for cogent analysis. Shortage of a rich vocabulary may be part of the problem, but chances are that analytical lethargy plays a larger role. For example, we frequently use the word "entrepreneurship" to describe the organizational (and sometimes purely managerial or administrative) task of founding a business, as though that were the sole role of the entrepreneur. Manifestly it is important, but, just as clearly, entrepreneurial innovation does not cease with the formation of a business firm. Innovation and discovery may and do regularly occur in all phases of a business enterprise, from production to finance to human resources to marketing and so on, even though these areas of potential innovation are rarely seen as quintessential venues of the entrepreneurial function in the large, publicly-held corporations. Also, as is well known, technological innovations within such corporations may on occasion be nothing more than the product of the routinized exercise of a managerial function.

The risk-taking function too is often confounded with the entrepreneurship function, even though each of these functions may exist exclusively, with no trace of the other, since, among other reasons, economic risk can obviously be transferred by contract to someone who bears no entrepreneurial responsibility. Successful innovation comes in many forms and in many areas of business, far too many, as we shall discuss below, to allow us to plan meaningfully to compensate for specific cases as they appear.

The third source of fuzzy analysis of corporate affairs arises with the failure to be clear about what is meant by "compensation." In common parlance, we generally mean this term to cover salaries, bonuses, stock options, and various perks of office transferred to an employee in exchange for the performance of a specified amount and quality of effort. And here things begin to get complicated, for surely compensation is, in an economic, non-legal sense of the term, every benefit (including future opportunities) offered up on one side of a contract. That may include, for example, working conditions, access to exogenously valuable knowledge, interpersonal relationships, potential for promotion, reputational gains, and lax monitoring, none of which ever shows up explicitly in contracts, but each of which may be a very important part of the total compensation picture.

When we put these three complexities into one mix, we begin to see the difficulty of making sense of the entrepreneurial compensation quagmire. We rarely even know when the entrepreneurial function is being rewarded in corporate development (apart, perhaps, from the case of stock granted to a promoter on the formation of a firm), as there are too many confounding circumstances to allow discrete measurement. A corporate founder may also be the inventor of a product which is to be marketed by a company that he or she forms by assembling his or her own personal capital and labor and that of other contributors. The founder may own shares and, at the same time, draw a salary and other compensation, compete in the market for corporate managers, retire early, trade profitably in the stock market, and enjoy the regard of his or her community. Which of these is the entrepreneurial compensation, which is the return to capital, which is the managerial compensation, and which is just plain luck? No amount of regressing can give us a clear answer to this question.

To complicate matters further, we do not even have general agreement on exactly how to define the entrepreneurial function. The Austrian-school economists, particularly Israel Kirzner, have offered the most integrated, robust and consistent theory of the entrepreneur, although that approach is still handled at arm's length by most mainstream economists.[2] The Austrian theory has the entrepreneur as the "discoverer" of new

[2] *See* ISRAEL M. KIRZNER, COMPETITION AND ENTREPRENEURSHIP (1973); ISRAEL M. KIRZNER, PERCEPTION, OPPORTUNITY, AND PROFIT: STUDIES IN THE THEORY OF ENTREPRENEURSHIP (1979); Israel M. Kirzner, *Uncertainty, Discovery, and Human Action: A Study of the Entrepreneurial Profile in the Misean System*, *in* METHOD, PROCESS, AND AUSTRIAN ECONOMICS: ESSAYS IN HONOR OF LUDWIG VON MISES 139 (Israel M. Kirzner ed. 1982); Israel M. Kirzner, *Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach*, 35 J. ECON. LITERATURE 65 (1997). For additional sources discussing the Austrian concept of entrepreneurship, see AUSTRIAN ECONOMIC AND ENTREPRENEURIAL STUDIES (Roger Koppl ed., 2003); Roger Koppl & Maria Minniti, *Market Processes and Entrepreneurial Studies*, *in* HANDBOOK OF ENTREPRENEURSHIP RESEARCH: AN INTERDISCIPLINARY SURVEY AND INTRODUCTION 81

combinations of resources, new ways of doing things, new products or innovations in marketing, a new organizational form, or, more succinctly, whatever shakes up the allocational status quo. But this approach, which is followed in this paper, with its focus on a kind of Knightian uncertainty[3] about what an entrepreneur will produce, confounds the compensation issue even more, since the output of the entrepreneurial function can never be anticipated or known in advance. If the innovation were predictable, it would no longer be entrepreneurial, and, as we have seen, even when its presence is sensed after the fact, it is generally too difficult to separate from other functions to allow precise reward. Still, we know that an entrepreneurial function exists because there could be no real economic progress without this function. Joseph Schumpeter pointed out long ago that entrepreneurship is the very factor which avoids a perfectly static equilibrium, a circular system with no progress or growth.[4]

So there is a howdy-do, an economic function necessary to the very idea of progress but with no obvious way of specifically identifying it or compensating for it. But the operative term there is "obvious," since we can surmise that, in one way or another, the function is being provided and, if it is being provided, then it is most likely being compensated for. Frank Knight's hunch that entrepreneurship in aggregate was provided freely in a market economy because of the truly "residual" nature of compensation for such services[5] may be correct, and there is some corroborating evidence for the proposition.[6] However, Knight's claim was made before anyone even recognized the

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(Zoltan J. Acs & David B. Audretsch eds., 2003). *See also* William J. Baumol, *On Austrian Analysis of Entrepreneurship and My Own, in* AUSTRIAN ECONOMIC AND ENTREPRENEURIAL STUDIES, *supra*, at 57, 57 ("[W]hat the literature has produced is largely attributable to the Austrian economists . . . . But in standard microtheory [entrepreneurs] are completely invisible.").

[3] Uncertainty is an unpredictability so great that we cannot even assign an approximate risk of its happening. *See* FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT ch. 7 (1921).

[4] JOSEPH A. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT (1911).

[5] *See* KNIGHT, *supra* note 3, chs. 10–11; Frank H. Knight, *Profit and Entrepreneurial Functions*, 2 J. ECON. HIST. (SUPP.) 126 (1942).

[6] *See, e.g.*, Barton H. Hamilton, *Does Entrepreneurship Pay? An Empirical Analysis of the Returns to Self-Employment*, 108 J. POL. ECON. 604 (2000).

problem of entrepreneurship in the large, publicly-held corporations, and it seems more likely that this function is now being provided on a more or less conventional market basis. However, in all fairness, we should note that Knight did not claim that more compensation would not elicit more entrepreneurial services, only that society had received more entrepreneurial services than was paid for.

Schumpeter famously predicted that, since the large corporation could provide no way to compensate the entrepreneurial function, it would ultimately disappear into a bureaucratic black hole without innovation.[7] But large corporations are still here, even larger than when Schumpeter wrote, and we still do not live in this Schumpeterian static world. Entrepreneurship in the sense of discovery and unpredictable innovation is indisputably going on in very large corporations, and it is not all routinized. Certainly, it is more likely that this entrepreneurship is being compensated for, albeit not in a fashion captured in simple supply and demand models[8] or taught in business school theories of executive compensation or implicitly envisioned in corporation-law casebooks. The mere fact that we cannot account for this exchange in our double-entry bookkeeping or even in our advanced econometric techniques does not make the likelihood of some form of compensation any less real.

The problem is not so critical if one thinks of the entrepreneurial services produced by an Edison or a Ford or a Gates. They were, in addition to being entrepreneurs under anyone's definition, capitalists, managers, inventors, risk takers, and employees of the companies they founded. Whether they became enormously wealthy because of their exercise of the entrepreneurial function – or of the capitalist or managerial one – is hardly of great social moment. But for myriad individuals otherwise connected with the large, publicly-held corporations the problem can become acute. Indeed, a good deal of the modern discussion of designing compensation plans to coordinate the interests of owners

[7] SCHUMPETER, JOSEPH A., CAPITALISM, SOCIALISM AND DEMOCRACY pt. 2, ch. 12 (1942).

[8] PENROSE, EDITH, THE THEORY OF THE GROWTH OF THE FIRM, 3d ed. 1995, p. 75: "There is no supply curve or production function into which such services can be fitted, but they are nevertheless inputs in production."

and managers is, in effect, a discussion of how to motivate entrepreneurial services, even though we rarely recognize it as such.

Business improvement and innovation may often be indistinguishable from normal good management, and yet the two are separate and distinct functions, one relating to the performance of a known and describable function and the other the provision of something totally unpredictable. Furthermore, entrepreneurial contributions may be made by people both inside and outside the organization, which is, by definition, not possible for managerial functions. And, perhaps most important to this discussion, often we cannot even recognize an entrepreneurial contribution – or its value – until long after it has occurred.

While we tend to think of entrepreneurial contributions as the large, creative-destruction type of changes, the truth is commonly very different. It may be the case that individual, discrete examples of entrepreneurship occur with enormous frequency, albeit in small or even barely noticeable increments. Discovering the incandescent lamp is one thing, but finding a new way to organize the inputs on an assembly line, clearly a candidate for being called entrepreneurial, will usually not receive that same degree of attention or acclaim, at least until it shows up on the proverbial bottom line. Even then the real source of the revenue gain may be difficult to specify. Also, it may take years for the stock market to register the new value created, since the increase in accounting earnings may be years away.[9] The stock market may be efficient, but it must have information inputs to do its job.

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[9] This example is merely one of many reasons it would be better public policy to encourage early utilization of new information in the stock market instead of hindering, delaying and distorting it, as we now do:

> The new approach would suggest that it is undesirable to have laws discouraging stock trading by anyone who has any knowledge relevant to the valuation of a security. Thus, assembly-line workers, administrative assistants, office boys, accountants, lawyers, salespeople, competitors, financial analysts and, of course, corporate executives (government officials are another story) should all be encouraged to buy or sell stocks based on any new information they might have. Only those privately enjoined by contract or other legal duty from trading should be excluded.

Henry G. Manne, *The Welfare of American Investors*, WALL ST. J., June 13, 2006, at A16.

We do sometimes recognize the innovations of employees (but never of outsiders) with such compensation forms as bonuses, new grants of stock or stock options, or increased salary.[10] Equity forms of compensation, such as stock or stock options, may also include a component for entrepreneurial actions to the extent that such compensation has an ex ante motivating force for innovation. But it is unlikely that these forms of compensation, without perhaps reaching enormous size, can ever motivate a desirable or efficient level of entrepreneurial activity.[11] Suffice it to say for now that they were never designed expressly with compensation for entrepreneurial services in mind. On that Schumpeter was certainly correct when he said that "the fact that personal gain, beyond salary and bonus cannot, in corporate business, be reaped by executives except by illegal or semi-illegal practices shows precisely that the structural idea of the corporation is averse to it."[12]

There are fundamental problems with each of these as forms of compensation to the corporate entrepreneur, but Schumpeter was undoubtedly too hasty in proclaiming the large corporation as incompatible with innovation. I dealt with this topic some years ago

[10] For a surprisingly inadequate discussion of these forms of entrepreneurial compensation in an otherwise superb discussion of the role of the entrepreneur in large firms, see Frederic E. Sautet, "An Entrepreneurial Theory of the Firm," 2000, pp. 101-104.

[11] We might debate about what the efficient or optimal level of entrepreneurial services is, since the function does not neatly fit into traditional economic analytics of efficient output. We can conceive of not having enough entrepreneurship, as is the case with many underdeveloped countries, but it is difficult to make sense of any concept of over-production of entrepreneurship. However, for the view that there is an optimal level of ignorance, see STIGLITZ, JOSEPH E., WHITHER SOCIALISM? 1994. Perhaps the statement in the text should refer to motivating entrepreneurial activity without reference to the amount as being efficient, and it might be one case in which the efficient level is also the maximum level. But in the scheme of using insider trading to compensate entrepreneurial activity, as proposed below, there could never be such a thing as "too much" incentive: if the development is not worthy, it will not be reflected in a higher stock price and, therefore, will not reward the developer.

[12] SCHUMPETER, *supra* note 7, at 156 n.1. But, as we shall see, the system does allow an appropriate form of compensation, insider trading, although Schumpeter may have included that among the illegal or semi-illegal forms of compensation. His failure to clarify this point has always been something of a mystery.

and will not repeat that discussion here.[13] But, for the most part, the problem is that the settling up with bonuses or additional compensation is always done post hoc and, therefore, is subject to great disagreement about the amount, the proper identity of the recipients of this extra compensation, and the correct evaluation of the individual's contribution and whether any reward is appropriate at all. This problem may be especially acute because of the special psychological characteristics of great entrepreneurs, most notably optimism, which Knight so insightfully noted.[14]

Certain parts of the discussion I tried to initiate on this subject many years ago are perhaps even more relevant today than they were then. To be consistent with the idea of the entrepreneur as a creator of new combinations and the discoverer of new ideas or information, a system of compensation is required that can more precisely and more quickly measure the true present value of these contributions than can a compensation committee. A prior holding the company's stock (even assuming that the stock market will accurately measure the value of the innovation) can never perform the appropriate reward function, since the value of the reward is shared equally, per share, with all other shareholders. That reflects the capitalist's function, not the entrepreneur's. Furthermore, the amount of stock held by the entrepreneur would have been determined long before the innovation occurs and for reasons generally unconnected to the contribution. Only if the entrepreneur is also the owner of all or the bulk of the company's shares (thus combining two economic functions in one person) can this form of reward be considered an appropriate form of compensation for the entrepreneur. But then we are talking about the likes of the early Ford or Edison examples and not about lesser mortals in modern publicly-held companies.

Furthermore, the idea of entrepreneurs receiving their reward via stock ownership misses another salient feature of true entrepreneurship. Stock ownership entails risk, which, as explained above, is not truly a part of the entrepreneurial function. While stock price will more accurately than any other mechanism evaluate and price the contribution of the

[13] *See* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET ch. 9 (1966).

[14] KNIGHT, *supra* note 3, at 283–86.

corporate entrepreneur, full exploitation of (in the sense of being rewarded for) new information developed by the entrepreneur can be achieved only by trading in the stock and not simply by owning it. We should anticipate that share trading rather than share holding would be the hallmark of the corporate entrepreneur in the large, publicly-held companies.

Thus, if the United States government had not progressively outlawed insider trading since 1961[15], we should expect to find that the wealth of many individuals connected with large corporations, particularly but by no means exclusively those responsible for the progress and development of the business, is explained as much or more by share trading than by share ownership.[16] But as insider trading has been increasingly demonized and criminalized, other forms of compensation have had to be substituted for this one, and the amounts required of these other forms of compensation, as discussed in more detail below, are apt to appear scandalously high in order to approximate appropriate compensation for entrepreneurs, another good example of the unintended and unforeseen consequences of regulation.

This analysis may also help explain a persistent conundrum in modern corporate economics: why are larger corporations, generally speaking, less entrepreneurial than smaller ones? Surely Schumpeter's pop-sociological theory that bureaucratic, risk-averse types will dominate large corporations is not a robust explanation. We see too many examples to the contrary. A more cogent answer flows directly from our assumptions regarding entrepreneurial personality, compensation, and a little arithmetic.

As a corporation grows in absolute size, the effect of any given development on share price becomes less and less in absolute terms. That is, a billion dollar development in a publicly-held corporation with a market capitalization of 50 billion dollars will have half

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[15] *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), is considered to be the starting point of modern insider trading regulation.

[16] The same is very likely true for pre-1961 companies, although no one to my knowledge has analyzed this issue.

the per share price consequence of the same development in a company with a 25 billion dollar capitalization. Thus, if entrepreneurs want large gains and small risk,[17] we should expect persons with true entrepreneurial personalities, that is with high confidence levels in Knight's terms, to be attracted to smaller corporations, where they can realize greater trading profits from the same level of contribution.

This theory does not preclude innovation and entrepreneurship in larger corporations; it merely suggests that smaller publicly-held firms would, in the absence of rules against insider trading, have a comparative advantage in attracting employees with a more entrepreneurial bent. Thus another unnoticed and unintended consequence of insider trading regulation has been to discriminate against smaller publicly-held corporations in relative favor of larger ones. The regulation, to the extent that it is effectively enforced, removes one of the most significant competitive advantages smaller companies have. This analysis could help explain why there was no great hew and cry from America's top businesses when the Securities and Exchange Commission ("SEC") high-handedly wrote new law on insider trading in 1961.[18]

But even without the implicit subsidy from insider trading regulation, the larger firms still have means to compete for entrepreneurial employees. To compete effectively in the market for entrepreneurial talent with the smaller publicly-held companies, the larger companies would have to – and do – offer higher salaries and other perks than would the smaller ones. Thus we have a new explanation for the correlation often found between the relative size of a company and the compensation levels of its executives. We may also have found a new and cogent, if partial, explanation for the apparently scandalously high salaries and other perks in the large, publicly-held companies that have come to public attention in recent years. It takes a lot of straight salary to compensate an executive for the loss of the right to trade on new information. As Jensen and Murphy

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[17] This notion is derived from both Knight's and Kirzner's view of the entrepreneur. For a general discussion of these views, see Sautet, supra n. 10.

[18] For other possible explanations of why this development was met with silence, see Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark*, 31 J. CORP. L. 167-185 (2005).

argued many years ago, the form of compensation may count for more than the level, although they did not consider insider trading in the mix.[19]

For these reasons and perhaps others, specific amounts of salary or stock will probably never capture the essential required characteristic of effective entrepreneurial compensation. The incentive system must appeal to the confident nature of the entrepreneur as well as to the entrepreneurial instinct to "cash in big" from new contributions.[20] Facing a compensation committee's ex post evaluation of an invention will hardly appeal to this type of personality. As we have seen, all conventional compensation devices suffer from the problem of valuation of innovations as well that of determining the person directly responsible for a new development and deserving of reward, matters about which the innovator and his or her employer will almost certainly disagree.[21]

The incentive to act entrepreneurially must exist in advance of the contribution and with an understanding that in fact nothing of value may be developed, another reason that it is so difficult to design an ex ante compensation system for entrepreneurial developments in a large corporation. In this sense, compare the research scientist who is hired to invent or develop something, a cure for cancer for instance, with an inherently uncertain outcome. There obviously can be no guarantee of the results of such research, and yet the compensation and its form must be appropriate to entice the person to do the work. A salary combined with the right to trade in the stock market on any new information

[19] *See* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentive*, 98 J. POL. ECON. 225 (1990) ("On average, corporate America pays its most important leaders like bureaucrats. Is it any wonder then that so many CEOs act like bureaucrats rather than the value-maximizing entrepreneurs companies need to enhance their standing in world markets?").

[20] In this context the stock option fails for the same reason as prior stock ownership does.

[21] As well they should. These matters involve inherent uncertainty, and it can be safely predicted that mistakes will occur. The insider trading compensation device does not entirely dispense with these errors, but it does generally compensate for entrepreneurial activity while doing away with the disagreements and personal involvements in compensation decisions. Furthermore, it does no harm and entails some other real benefits in the process. *See* MANNE, *supra* note 13.

produced will neatly satisfy the requirements of an appropriate compensation system for this kind of effort. Furthermore, the incentive should ideally be able to go to any individual in the corporate system who might, whether predicted to or not, to make an entrepreneurial contribution. In some sense, it is a personality trait that the employer wants and not necessarily or exclusively an individual of known skills and propensities, although that too must occur. Allowing trading on new information produced will again satisfy this requirement.

So an entrepreneurial compensation system must possess some unusual characteristics if it is to successfully attract the sought-after services. It must appeal to the personality of the entrepreneurial type; it must avoid valuation and attribution issues post hoc; and it must ideally motivate any prospective employee to perform as an entrepreneur. It is impossible to find a system that will meet all these requirements other than the right of corporate employees with valuable new information to buy shares on that news in advance of public disclosure.

Insider trading as a form of compensation also has some peculiar characteristics that will distinguish it analytically from other forms of compensation. The most obvious difference is that the value of individual stock trades to be made in the future cannot by their nature be determined in advance, even though, as noted earlier, a real market value must be attached to a general right to engage in insider trading, a kind of generalized "call" on stock. It cannot be assumed, even with the most efficient stock market, that the profits from trading on inside information will correctly and precisely measure or evaluate a corporate entrepreneur's contributions, even though in some cases this allocation of trading profits may happen. Obviously, the amount of stock the insider is willing to purchase on the information that he or she created or learned will vary with a number of exogenous circumstances, including the availability of credit to the employee[22] and the certainty of the information's value. Furthermore, stock market prices

[22] This point implicates the discussion in my 1966 book of investment bankers performing some sort of clearinghouse function for new information, thus allowing corporate entrepreneurs to virtually trade information with other corporate entrepreneurs through time and trade knowledgably in securities of

at any given moment reflect a variety of other information inputs, so that it will always be difficult to isolate and measure the value of one particular entrepreneurial development. Similarly, trading quickly, *i.e.*, buying and then selling right after the disclosure, merely reduces the risk of stock holding; it does not remove it entirely.

Still, insider trading is the system par excellence of compensating entrepreneurs in the large, publicly-held corporations, and it does not matter one whit that the amount the employee realizes by his or her trading may be more or less than the contribution is worth, that the wrong person may be rewarded with this right, that profit can be made from bad news as well as good news, or that the system might seem unfair to economics-challenged regulators and moralists.[23] The system, as we shall explain below, is the critical factor. Of course, there are myriad other considerations in the insider trading debate. The present discussion is limited to the appropriateness of insider trading as a form of entrepreneurial compensation in the large, publicly-held corporations.[24] Unfortunately, only a handful of sources have addressed critically the entrepreneurial compensation argument which I offered in substantially these terms over forty years ago,[25] although several commentators have acknowledged the value of the right to trade

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various companies instead of going heavily into debt in order to fully exploit one significant piece of information. *See* MANNE, *supra* note 13, at 69–71.

[23] There are after all other advantages to this system too, but they are not being discussed here. *See generally* MANNE, *supra* note 13.

[24] The "mea culpa" I entered in my 2005 article, Manne, *supra* note 18, at 170–74, referred only to the problem of trying to design an executive compensation plan in advance utilizing the right to trade in shares as an explicit part of the package. I certainly did not intended to retract the idea that a general rule of allowing insider trading was the best device we could imagine for appropriately rewarding entrepreneurial services in the large, publicly-held corporations.

[25] *See* Antonio E. Bernardo, *Contractual Restrictions on Insider Trading: A Welfare Analysis*, 18 ECON. THEORY 7 (2001); Frank H. Easterbrook, *Insider Trading as an Agency Problem*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 81 (John W. Pratt & Richard J. Zeckhauser eds., 1985); Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051 (1982).

on undisclosed information as a form of compensation, another way of saying that this right does have a market value.[26]

It should be noted here that the use of insider trading rights as a form of compensation has the double advantage of applying to everyone, either within or outside the company, since the incentive will have a generalized effect on all employees and related outsiders. This system will influence the general corporate culture nd will provide incentive for innovation by everyone, not merely those who might be explicitly described as entrepreneurs. In that sense, it is perhaps a little misleading to refer to insider trading as a form of compensation for any specific individual. It is an incentive device available to anyone, especially employees, who chooses to take advantage of it, and it will go a long way towards producing a corporate culture of innovation. That, after all, is what is wanted, not some new provision to add to the standard form employment contract. While such a corporate culture may generate considerable employee attention to the stock market, as has been complained about insider trading, that actually should be seen as a part of the solution and not a part of the problem.

Today with the regulation, criminalization, and vilification of insider trading many, probably most, corporate employees – particularly the entrepreneurial ones who would be the easiest for regulators to spot – would not try to profit from an innovation by trading in their company's securities before the innovation's value is reflected in the stock price as a result of public disclosure. But along with that hesitation to trade undoubtedly goes a loss of incentive for developing new ideas and certainly the loss of a culture that could encourage entrepreneurship. It is inconceivable that the outlawing of insider trading in the United States has not had a significant deleterious effect on the long-term

[26] *See* Lucian Arye Bebchuk & Chaim Fershtman, *The Effects of Insider Trading on Insiders' Effort in Good and Bad Times*, 9 EUR. J. POL. ECON. 469 (1993); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Ronald A. Dye, *Insider Trading and Incentives*, 57 J. BUS. 295 (1984); Jie Hu & Thomas H. Noe, *Insider Trading and Managerial Incentives*, 25 J. BANKING & FIN. 681 (2001). These sources suggest that, under certain conditions, insider trading could serve as an efficient compensation mechanism, but none of them makes a distinction between entrepreneurs and managers.

performance of our publicly-held companies. Ironically, the potential impact of insider trading regulation on corporate entrepreneurship was recognized at the very dawn of federal securities law.[27]

Two factors have prevented this bit of "fairness" regulation from totally destroying large corporate enterprises in the fashion Schumpeter predicted. The first is that, at least until recently, we did not consider controlling the level of other forms of compensation which might – probably inefficiently and expensively – substitute for insider trading as an incentive system for entrepreneurial services.[28] The other is the near impossibility of

[27] As a member of FDR's inner circle remarked,

> [T]o make sure that management shall be limited in its profits motive to long-term periods, the authors [of the proposed National Securities Exchange Act of 1934], by Sections 15(b)(1) [in the final version, Section 16(b) that was directed against "short-swing" transactions], 19(d) [coverage of transactions by family members], and the option provision of Section 8(a)9 [prohibition of transactions in options], convert management into a mere salariat and bureaucracy which cannot, excepting though increased salary and "lock-in" investments share in entrepreneurial profits through exercising options as extra reward or making judicious investment even for cash in their own companies with the expectations of selling out when occasion arises regardless of any fixed period.

Alexander Sachs, Lehman Corp., Memorandum on Obstacles in the Securities Exchange Act to Efficient Investment and Enterprising Management II-1–II-2 (Feb. 1934).

[28] On the other hand, several empirical studies attempted to test whether potential trading gains are reflected via a decrease in the cash portion of compensation packages, although they yielded mixed results. *Compare* Kevin J. Hebner & Takao Kato, *Insider Trading and Executive Compensation: Evidence from the U.S. and Japan*, 6 INT'L REV. ECON. & FIN. 223 (1997) (reflected), *and* Darren T. Roulstone, *The Relation Between Insider-Trading Restrictions and Executive Compensation*, 41 J. ACCT. RES. 525 (2003) (same), *with* Steffen Brenner, On the Irrelevance of Insider Trading for Managerial Compensation (Mar. 20, 2009) (unpublished manuscript, on file with author) (not reflected), *and* Teresa Diane Trapani Teeuwen, An Investigation of the Relationship Between CEO Compensation and CEO Trading Profits (May 1991) (unpublished Ph.D. dissertation, University of Kansas) (on file with author) (same). *See also* Wei Zhang et al., *Insider Trading and Pay-Performance Sensitivity: An Empirical Analysis*, 32 J. BUS. FIN & ACCT. 1887 (2005) (an empirical study arguing that, "in the presence of more aggressive insider trading, shareholders and the managers negotiate compensation contracts that are less sensitive to performance").

effective enforcement of laws against insider trading.[29] While the publicity-motivated prosecutions and the propaganda system that have long characterized the SEC's campaign against insider trading deter some people from engaging in the practice, all indications are that it still flourishes, perhaps even done by the right people sometimes.[30] Rarely is there a major news story about a corporation without prior movement in the indicated direction in the stock market. Someone is cashing in on the development; it would certainly be to everyone's benefit if it were generally the people responsible for it.

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[29] Among other reasons for this difficulty of enforcement is the fact that, under the right circumstances, as much gain can be had from knowing when not to sell or not to buy as from the obverse. But, since there is no "transaction," this is not generally a violation of Rule 10b-5.

[30] *See, e.g.*, *Illegal Insider Trading: How Widespread Is the Problem and Is There Adequate Criminal Enforcement?: Hearings Before the S. Comm. on the Judiciary*, 109th Cong. (2007); Brent Shearer, *Forbidden Fruit*, MERGERS & ACQUISITIONS, Oct. 2007, at 66.