

ENTREPRENEURSHIP, COMPENSATION, AND THE CORPORATION

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ABSTRACT: This paper 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 large, publicly held companies. Compensating for entrepreneurial services in such companies, *ex ante* or *ex post*, is problematic—almost by definition—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.

KEYWORDS: entrepreneurship, compensation, corporation, innovation, insider trading

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Much of the economics literature on the compensation of various personnel involved with large, publicly held companies has failed to come to grips with three important economic realities. The first is that there is no single model of corporate organization that will turn up valid answers for all occasions.¹ The corporate entity is a many-splendored thing, ranging from the elemental, one-person shop 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, voting rights, contractual provisions (charters and by-laws included) relating to managerial authority and compensation, dividend policies, organizational culture, norms, and applicable laws and regulations.

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 large, publicly held companies. Furthermore, as it is well known, technological developments within such corporations may on occasion be nothing more than the product of the exercise of a routine managerial function, although they will be popularly referred to as “innovations.”

¹ The definition of “corporation” in this paper is broadened to include corporation-like business associations, some of which have publicly-traded equity securities. For a discussion of the importance of non-corporate forms and the “incorporation,” see Ribstein (2009a, b, c).

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. For example, 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 either to simplify it as one form of economic function or 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, pursuant to an employment contract, to an employee in exchange for the performance of a specified amount and quality of effort. Here things begin to get complicated, for surely real compensation, in an economic and non-legal sense of the term, is every benefit or positive utility (including discounted future opportunities) offered up on one side of the employment contract. These benefits are rarely contemplated in discussions of corporate employee compensation. They may include, for example, working conditions, access to exogenously valuable knowledge, interpersonal relationships, potential for promotion, reputational gains, and lax monitoring. These may show up explicitly on occasion in employment contracts, but, at the margin, each of these 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 to be marketed by a company formed 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. Several representatives of the Austrian School of Economics, particularly Israel Kirzner, have offered an integrated, robust, and consistent theory of the entrepreneur (Kirzner, 1973; 1979; 1982; 1997)² and distinguished various entrepreneurial and non-entrepreneurial functions,³ although that approach is still handled at arm's length by most mainstream economists.⁴ This theory has the entrepreneur as the "discoverer" of new combinations of resources, new ways of doing things, new products or innovations in marketing, new organizational forms, or, more succinctly, whatever shakes up the allocational status quo. But the closely related approach followed here, with more emphasis on a kind of Knightian uncertainty⁵ about what an entrepreneur will produce, confounds the compensation issue even more, since the output (substance and value) 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 measurement for reward purposes. This "loop" presents a great anomaly. We know that an entrepreneurial function exists because

² For additional sources discussing the Austrian concept of entrepreneurship, see Holcombe (2003), Klein (2008), Koppl (2003), and Koppl and Minniti (2003).

³ For an Austrian analysis of various functions performed by entrepreneurs, capitalists, and managers, as well as possible overlaps among these categories, in the context of corporate governance, see Klein (1999). For a description of the development of the entrepreneur-capitalist-manager taxonomy in economic theory, including the contributions of the Austrian School of economics, see Formaini (2001).

⁴ See Baumol (2003, p. 57) ("[W]hat the literature [on entrepreneurship] has produced is largely attributable to the Austrian economists.... But in standard microtheory [entrepreneurs] are completely invisible").

⁵ Uncertainty is an unpredictability so great that we cannot even assign an approximate risk of its happening. See Knight (1921, chap. 7).

there could be no real economic progress, which we witness every day, without this function. Joseph Schumpeter pointed out long ago that entrepreneurship is the factor that lets us avoid a perfectly static equilibrium, the famous circular system with no progress or growth (Schumpeter, 1934, chap. 2).

So there is an *howdy-do*, an economic function necessary to the very existence 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 (Knight, 1921, chs. 10–11; 1942) may be correct, and there is some corroborating evidence for the proposition (Hamilton, 2000). But Knight’s claim was made before a widespread recognition of the problem of entrepreneurship in large, publicly held companies, and it seems more likely that this function is now being provided on a more or less conventional market basis. That is, entrepreneurship is being paid for, and more pay elicits more of this activity. 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 were paid for.

Schumpeter famously predicted that the large corporation would ultimately disappear into a bureaucratic black hole without innovation (Schumpeter, 1942, pt. 2, chs. 12, 14). One of the implicit rationales for this prediction is that such entities could provide no way to compensate the entrepreneurial function. But large corporations are still here, even larger than when Schumpeter wrote, and we still do not live in this Schumpeterian static corporate world. Entrepreneurship in the sense of discovery and unpredictable innovation is indisputably going on even in very large corporations, and it is by no means fully routinized. Certainly, it is more likely that the entrepreneurial function is being compensated for, albeit not in a fashion captured in simple supply and demand models,⁶ taught in business school theories of executive compensation, or implicitly

⁶ See Penrose (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”).

envisioned in corporation-law casebooks. The mere fact that we cannot account for this exchange in our standard double-entry bookkeeping or even with 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 large, publicly held companies, the problem can become acute. Indeed, a good deal of the modern discussion about designing compensation plans to coordinate the interests of owners and managers is, in effect, a discussion of how to motivate or reward entrepreneurial services, even though we rarely recognize it as such.⁷

Business improvement and innovation may often be indistinguishable from normal good management, and yet they are separate and distinct functions, one relating to the performance of a known and describable function and the other to the development 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. An additional—and perhaps most important—point to this discussion is that often we cannot even recognize an entrepreneurial contribution—or its value—until long after it has occurred.

⁷ Indeed, it is safe to say that the vast amount of discussion of faulty compensation plans for executives caught up in the recent financial chaos misses the mark widely. Their contracts may well have encouraged too much risk taking, i.e., more than the shareholders would have wanted *ex ante*, as has been widely alleged. See Lewis (2010); Posner (2009); U.S. House of Representatives (2009). But the risk-taking function is not the same as the entrepreneurial one, and there is simply no way, even *ex ante*, to determine that employees were motivated to produce too much entrepreneurial innovation. Buying ever greater amounts of subprime mortgage-backed securities according to a computerized algorithm is the essence of an administrative function which bears no relation to anything that might appropriately be termed entrepreneurial. Inventing the algorithm, however, is a different story.

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.⁸ These bits and pieces of entrepreneurship may be “packaged” together with virtually every managerial and even administrative task. Discovering the incandescent lamp is one thing, but finding a new way to feed in the inputs on an assembly line, clearly a possible 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 books of the company to register the new value created.⁹ The stock market may be “efficient” in the sense of processing available information, but it must have information inputs to do its job.

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-based

⁸ Schumpeter himself noted that “the entrepreneurial element may be present to a very small extent even in very humble cases and in these the entrepreneurial function may be all but drowned in other activities” (Schumpeter, 1949, p. 70). This piece, written shortly before Schumpeter died and probably not in its absolutely final form, represents the author’s major sally into an explanation of the entrepreneurial function in connection with large corporations. Unfortunately, he never noted the ongoing problem of compensation for this function.

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 our regulatory scheme now does:

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. (Manne, 2006, p. A16)

¹⁰ In an otherwise superb discussion of the role of the entrepreneur in large firms in Sautet (2000, pp. 101–104), there is still a quite inadequate discussion of these forms of entrepreneurial compensation.

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*, as we sometimes do see, 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 perhaps inadvertently 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” (Schumpeter, 1942, p. 156 n.1).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.¹³ For the most part, the problem is that the settling up with bonuses or additional compensation is

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 (1994, pp. 52–53). 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. In the scheme of using insider trading to compensate entrepreneurial activity, as is being proposed in this paper, there could never be such a thing as “too much” incentive. In other words, if the development is not worthy, it will not be reflected in a higher stock price and, therefore, cannot reward the developer.

¹² 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, as well as his omission of stock and stock options from this list, has always been a mystery. In his equally puzzling description of “the modern businessman, whether entrepreneur or mere managing administrator,” Schumpeter remarked that, “[w]hether a stockholder or not, his will to fight and to hold on is not and cannot be what it was with the man who knew ownership and its responsibilities in the full-blooded sense of those words” (Schumpeter, 1942, p. 156).

¹³ I dealt with this topic some years ago in Manne (1966a, b) and will not repeat that discussion here.

always done *post hoc* and, therefore, is subject to great disagreement about such matters as the appropriate amount, the proper identity of the recipients of the extra compensation, and the correct evaluation of each individual's contribution and whether any reward is appropriate at all. This problem becomes especially acute when we consider the special psychological characteristics of great entrepreneurs, most notably optimism, which Knight so insightfully noted (Knight, 1921, pp. 283–86).

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, information, or opportunities, a system of compensation is required that can more accurately and more quickly assess the true present value of these contributions than can a compensation committee, even if the allocational question remains open. A pre-existing equity stake in the company (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 or risk taker'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 unrelated 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 large, 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 is not necessarily or peculiarly a part of the entrepreneurial function. While the stock price will more accurately than any other mechanism evaluate and price the contribution of the corporate entrepreneur, full exploitation (in the sense of being rewarded for) of 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 large, publicly held companies.¹⁴

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 Yet, as insider trading has been increasingly demonized and criminalized, other forms of compensation have had to be substituted for this one. The amounts required of these other forms of compensation, as discussed in more detail below, are apt to appear scandalously high if they are 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—or rather be created by—large corporations (Schumpeter, 1942, pp. 141, 156) 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

¹⁴ To the extent that this observation is correct, it demonstrates how very misguided a great deal of the criticism of insider trading has been, beginning with the complaint, which was articulated in a pivotal book by Berle and Means (1932), about corporate managers owning too few shares.

¹⁵ *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), an administrative adjudication issued by the U.S. Securities and Exchange Commission ("SEC"), is considered to be the starting point of modern insider trading regulation, but it was many more years before anything that could be termed significant enforcement began. For sources analyzing different perspectives on the emergence of this phenomenon, see Dolgoplov (2008); Dooley (1980); Haddock and Macey (1987); Joo (2007).

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

company with a market capitalization of 50 billion dollars will have half 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 companies in relative favor of larger ones. The regulatory framework, 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 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.¹⁹ We may also have found a new and cogent, if partial, explanation for the apparently scandalously high salaries and other perks in large, publicly held companies that have come to public attention

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 (2000).

¹⁸ For other possible explanations of why this development was met with silence, see Manne (2005).

¹⁹ For a discussion of empirical studies analyzing this correlation, see Frydman and Jenter (2010, pp. 87, 90, 93).

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 Michael Jensen and Kevin Murphy 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.²⁰

For these reasons and perhaps others, specific amounts of salary or stock will probably never capture the essential requirement 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.²¹ 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 twin problems of valuing innovations and determining the person directly responsible for a new development who deserves to be rewarded, matters about which the innovator and his or her employer will almost certainly disagree.²²

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 why it is so difficult to design an *ex ante* compensation system for entrepreneurial developments in a large corporation. In this sense, consider the research scientist hired to invent or develop something with an inherently uncertain outcome, such as a cure for cancer. There obviously can be no guarantee of the results of such research, and yet the compensation and its form must be appropriate to entice

²⁰ See Jensen and Murphy (1990, p. 138) (“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?”).

²¹ In this context, the stock option fails for the same reason as prior stock ownership does.

²² As well they should. These matters involve inherent uncertainty, and it can be safely predicted that mistakes, judged *ex post*, 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 significant harm and entails some other very real benefits in the process (Manne, 1966b).

this person to do the work in the hopes of cashing in big. A salary combined with the right to trade in the stock market on any new information produced will generally satisfy the requirements of a compensation system to elicit the desired kind of effort exerted by such a scientist. Furthermore, the incentive should ideally be able to go to any individual in the corporate organization who might, whether predicted to or not, make an entrepreneurial contribution. In a real sense, it is a particular personality trait that the employer wants and not necessarily or exclusively an individual of known skills and propensities, although that too may occur. Allowing trading on new information produced again appears perfectly consistent with this requirement.²³

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—and possibly even outsiders—to act as an entrepreneur. It is hard even to imagine a system that will meet all these requirements other than the right of corporate employees with valuable new information to trade 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 transactions to be made in the future cannot by their nature be determined in advance, even though, as noted earlier, a

²³ As noted earlier, Schumpeter never explicitly addressed the problem of compensation for entrepreneurial services in large, publicly held companies. He does, however, have one passage that sounds surprisingly consistent with the argument being made in this paper:

If a man sets up a new industrial organization... the value of the assets that enter into this organization increases. This increase no doubt embodies, at least ideally, a discounted value of the expected surplus returns. But it is in this increase in asset returns itself rather than the returns that constitute the entrepreneurial gain, and it is in this way that industrial fortunes are typically created. (Schumpeter, 1949, p. 71)

If this notion were to be transformed into the entrepreneurial compensation problem in large, publicly held companies, it would seem to describe the process of profiting from insider trading.

real market value must be attached at least implicitly to a general right to engage in insider trading. 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, perhaps merely coincidentally, this correct allocation of trading profits may happen. Obviously, the amount of stock or other securities the insider is willing to purchase on the information that he or she created or learned about will vary with a number of exogenous circumstances, including the availability of credit to the employee²⁴ and the certainty of the information's estimated value. Furthermore, stock prices at any given moment reflect a variety of other information or misinformation inputs, so that it will frequently 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 (or vice versa), merely reduces the risk of holding corporate securities, but it does not remove it entirely.

Insider trading remains the system *par excellence* of compensating entrepreneurs in large, publicly held companies, 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 marginal value of the contribution, 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.²⁵ The system and not the payment, 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 large, publicly held

²⁴ 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 to trade knowledgeably in securities of various companies for the purpose of diversification instead of going heavily into debt in order to fully exploit one significant piece of information (Manne, 1966b, pp. 69–71).

²⁵ There are after all other advantages to this system too, but they are not being discussed here. See Manne (1966b).

companies.²⁶ Unfortunately, only a handful of sources have paid proper attention to the entrepreneurial compensation argument which I offered in substantially these terms over forty years ago,²⁷ although several commentators have recognized the value of the right to trade on inside information as a form of compensation, another way of acknowledging that this right does have a market value and thus could perform as a form of compensation.²⁸

It should be emphasized here that the use of insider trading rights as a form of compensation has the double advantage of applying to people both within and 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 and will provide incentives for innovation for everyone, not merely those who might somehow be explicitly described as entrepreneurs.²⁹ In that sense, it is perhaps misleading to refer to insider

²⁶ The clarification I entered in my 2005 article referred only to the problem of trying to design *ex ante* an explicit executive compensation plan that would utilize the right to trade on inside information as an explicit part of the package (Manne, 2005, pp. 170–174). I certainly did not intend 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 large, publicly held companies.

²⁷ See Bernardo (2001); Easterbrook (1985); Haft (1982). For a succinct summary of the compensation debate, see Bainbridge (2000, pp. 780–782).

²⁸ See Bebchuk and Fershtman (1993); Carlton and Fischel (1983); Dye (1984); Hu and Noe (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 as the appropriate recipients.

²⁹ Again Schumpeter seems to have understood the point:

[T]he entrepreneurial function need not be embodied in a physical person and in particular a single physical person. Every social environment has its own ways of filling the entrepreneurial function.... [T]he entrepreneurial function may be and often is filled co-operatively. With the development of the largest-scale corporations this has evidently become of major importance: aptitudes that no single individual combines can thus be... built into a corporate personality; on the other hand, the constituent physical personalities must inevitably to some extent, and very often to a serious extent, interfere with each other. In many cases, therefore, it is difficult or even impossible to name an individual that acts as "the entrepreneur" in a concern. The leading people in particular, those who carry the titles of president or chairman of the board, may be mere co-ordinators or even figure-heads.... (Schumpeter, 1949, pp. 71–72)

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 this device will go a long way towards generating a pervasive 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 willy-nilly result in considerable employee attention to the stock market, as has been complained about in connection with insider trading,³⁰ that actually should be seen primarily as a part of the solution and not significantly as 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 companies' 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 highly doubtful that the outlawing of insider trading in the United States has not had a significant deleterious effect on the long-term performance of our publicly held companies.³¹

Two factors have prevented this bit of "fairness" regulation from totally or at least in good measure from seriously injuring large,

³⁰ See Cox (1986, p. 646) (voicing a concern about "the manager's use of personal resources and time to trade in his firm's stock"); Haft (1982, p. 1063) (arguing that "[c]ompetition [for inside information] might . . . turn management information systems designed for corporate purposes into stock market ticker tapes").

³¹ Ironically—and somewhat inartfully—the potential impact of insider trading regulation on corporate entrepreneurship was perhaps recognized at the very dawn of federal securities regulation by a member of FDR's inner circle:

[T]o make sure that management shall be limited in its profits motive to long-term periods, the authors [of the bill that ultimately became the Securities Exchange Act of 1934]... convert management into a mere salariat and bureaucracy which cannot, excepting through 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. (Sachs, 1934, pp. II-1-II-2)

publicly held companies 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 that might substitute for insider trading as an incentive system for entrepreneurial services,³² and this tradeoff might become even more important because of different post-crisis proposals to limit explicit forms of executive compensation.³³ The other factor is the near impossibility of effective enforcement of laws against insider trading.³⁴ While the publicity-motivated prosecutions and the hyped-up propaganda 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 (Shearer, 2007; Pulliam et al., 2010; Strasburg and Bray, 2009; U.S. Senate, 2006), perhaps even done by the right people sometimes. Commonly, even today, a major news story about a corporation is preceded by a movement of the stock price in the direction indicated by the news. Traders are cashing in on the development; it would certainly be desirable if they were the same individuals who in some sense and in some

³² 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. For sources suggesting that such gains are indeed reflected, see Hebner and Kato (1997); Roulstone (2003); Henderson (2010). For sources suggesting the opposite, see Brenner (2011); Trapani Teeuwen (1991). There are other relevant studies on the link between insider trading and compensation. See Gayle and Miller (2009, pp. 527–528) (considering the proposition that, “[r]ather than discourage managers from benefiting from their insider knowledge, the board might optimally sanction it” and offering empirical evidence that “supports the hypothesis that rather than simply benefiting from their private information by structuring their compensation package in an advantageous way, managers are also motivated, through their work choices, to raise the mean of unanticipated abnormal returns”); Zhang et al. (2005, p. 1917) (presenting empirical evidence to suggest that, “in the presence of more aggressive insider trading, shareholders and the managers negotiate compensation contracts that are less sensitive to performance”).

³³ For a discussion of such proposals, see Seitzinger (2009).

³⁴ This difficulty was analyzed in Dooley (1980). 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 behavior is not generally a violation of the SEC's Rule 10b-5, the principal regulatory weapon against insider trading. Results in recent empirical studies relating to enforcement, however, have been a mixed bag, which probably reflects severe methodological problems. See Bris (2005); Gilbert et al. (2007); Prevoo and ter Weel (2010).

measure were responsible for positive developments rather than typical participants in complex and costly mechanisms employed by underground markets in information.³⁵

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³⁵ For an illustration of such a market, see Strasburg and Rothfeld (2010).

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