

INSIDER TRADING AND ENTREPRENEURIAL ACTION*

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The core function of entrepreneurs is to challenge incumbents. Henry Manne famously argued that prohibitions on insider trading serve to entrench large, publicly traded corporations. According to Manne, when insider trading is prohibited, large corporations increase compensation levels to compete for executive talent. But even modern compensation levels do not adequately reward entrepreneurial talent because innovations are difficult to value and finding the right person to reward for successful innovation is often impossible to do with confidence. Thus, Manne proposed that executive entrepreneurs within public corporations should be compensated through profits gained from insider trading. This Essay examines Manne's argument more closely in light of recent developments in entrepreneurship theory and insider trading law and concludes that prohibitions on insider trading can facilitate entrepreneurial action.

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In 1966, Henry Manne offered a provocative proposal to legalize insider trading as a means of promoting entrepreneurial action.¹ Manne imagined a “market for entrepreneurial services” in which large, publicly held corporations hired entrepreneurs to produce valuable innovations.² Rather than enticing entrepreneurs with traditional compensation in the form of salaries, bonuses, or stock options—which Manne argued were impossible to calibrate to particular levels of entrepreneurial service³—corporations would offer the opportunity to gain from insider trading, and entrepreneurs would be “attracted to those positions offering the greatest opportunity for them to make large, indefinite gains.”⁴ While many commentators have engaged Manne’s proposal, most have ignored Manne’s attempt to link insider trading to entrepreneurial action,⁵ focusing instead on the more general issue of whether insider trading aligns a manager’s incentives with shareholder wealth.⁶ This Essay takes the role of the corporate entrepreneur seriously and argues that the legalization of insider trading would actually have a dampening effect on corporate entrepreneurship. Moreover, this Essay posits that the incentive problems identified by Manne have already been solved by innovations in startup financing.

Critics of Manne’s proposal are legion. Some have argued that corporate entrepreneurs can, in fact, be compensated at appropriate

1. See generally HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966).

2. *Id.* at 155.

3. *Id.* at 132–38.

4. *Id.* at 155.

5. For a searching challenge to Manne’s conception of the entrepreneur, see James Boyle, *A Theory of Law and Information: Copyright, Spleens, Blackmail, and Insider Trading*, 80 CALIF. L. REV. 1413, 1508 (1992) (“Manne pins his hopes on a Faustian vision of entrepreneurship, a vision which puts innovation (and not mere labor) at the heart of the issue and which seeks to reconcile society to the granting of a monopoly rent by promising the entrepreneur the spin-off profits from her innovative actions.”). For other, more limited, challenges, see Judith G. Greenberg, *Insider Trading and Family Values*, 4 WM. & MARY J. WOMEN & L. 303, 326–29 (1998) (arguing that traditional gender roles shape the way courts think about insider trading regulation and that “Manne’s entrepreneur is the classic profit-maximizing male”); Jonathan R. Macey, *Securities Trading: A Contractual Perspective*, 30 CASE W. RES. L. REV. 269, 279–81 (1999) (arguing that the propriety of insider trading under Manne’s proposal “becomes ‘simply’ an applied executive compensation problem”).

6. See, e.g., Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 869 (1983) (arguing that reducing insider trading regulations may make sense because “both managers and shareholders have incentives to reach agreements ex ante that limit divergent behavior by managers[.]” (citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976))).

levels.⁷ Others have argued that legalizing insider trading could lead to internal inefficiencies in a firm⁸ or that the people who actually trade on inside information have little or no role in entrepreneurial action.⁹ Still

7. See Morris Mendelson, *The Economics of Insider Trading Reconsidered*, 117 U. PA. L. REV. 470, 489 (1969) (reviewing MANNE, *supra* note 1) (“It is wholly unrealistic to assume that if insider trading were completely prohibited, the corporate world would find no way to compensate the entrepreneur. If the entrepreneur’s contribution to the corporation is truly valuable and the corporation is shortsighted enough to fail to recognize and reward the innovation, there will be a competitor interested in attracting the entrepreneur.”); Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1094 (1985) (calling Manne’s argument a “non sequitur” because “[t]he wage market . . . is fully capable of responding to unique or valuable contributions.” (citing Mendelson, *supra*, at 489)). Seligman explains that “[i]f the corporation for which an entrepreneur works is unwilling to pay him his worth in the wage market, he may sell his services to a competitive firm and receive greater compensation”. Seligman, *supra*, at 1094 (citing Mendelson, *supra*, at 489).

8. See, e.g., Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1053–67 (1982); see also Laura Nyantung Beny, *Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate*, 32 J. CORP. L. 237, 244 n.33 (2007) (“If an innovator held her information completely private, neither she nor her firm would benefit because the innovation would never be developed. If she were to buy stock in the company before disclosing her idea, her investment would have to account for the likelihood that she could not sell her innovation within the firm, and she might be poorly situated to estimate this risk. Realistically, the type of insider trading that regulators have been concerned with often does not involve innovation at all but knowledge that a person secures because of her position in the firm, such as knowledge about what the next quarterly report will say. To the extent that innovation is involved, trading on the inside knowledge is likely to be sufficiently downstream from the original innovative or entrepreneurial spark so that many who did not contribute to its development will be able to benefit from it if they are allowed to trade on their inside knowledge.”).

9. See Boyle, *supra* note 5, at 1507 (stating that “individuals making insider profits are frequently far removed from a time or place or job in which they could perform any entrepreneurial service for the company” (quoting MANNE, *supra* note 1, at 156–57)); James D. Cox, *Insider Trading and Contracting: A Critical Response to the “Chicago School”*, 1986 DUKE L.J. 628, 653 (“[M]ost insider-trading cases have not involved those whose entrepreneurial or other managerial efforts have produced the value-increasing event that was traded upon. Instead, the defendants have been outside directors, professionals, or clerks whose assistance was used to complete the transaction, not to create it”); Merritt B. Fox, *Insider Trading in a Globalizing Market: Who Should Regulate What?*, 55 LAW & CONTEMP. PROBS. no. 4, 1992, at 263, 289 (noting that “even if the direction of the incentives created by insider trading is positive, the persons actually responsible for creating the positive events are likely to receive only a small portion of the total trading profits made on the news”); Mendelson, *supra* note 7, at 490 (“The plain fact of the matter is that not everybody who may gain from insider trading has participated in the innovation. And there is no real chance that the respective rewards to the various persons engaging in insider trading will be commensurate with their contributions to the innovation.”); Seligman, *supra* note 7, at 1094 n.55, 1095–96 (positing that “either insider trading would have to be legitimated for a large number of persons who do not perform an entrepreneurial function—for example, messengers, secretaries, bookkeepers, executives not performing entrepreneurial functions, and outside directors—or the corporation itself would have to take on substantial investigatory and enforcement costs to limit insider trading to appropriate entrepreneurs”

others have argued that insider trading is akin to receiving a lottery ticket,¹⁰ that it rewards the production of both good and bad information,¹¹ or that it is dependent on the insider's access to capital.¹² But these criticisms miss a fundamental objection to Manne's proposal—namely, that an entrepreneur cannot reliably gain from trading on the innovations that Manne describes.¹³

Manne constructs the connection between insider trading and entrepreneurial action on the foundation of Frank Knight's classic text, *Risk, Uncertainty and Profit*.¹⁴ Knight's goal in writing this book was to examine the role of the entrepreneur in the economic system and to explain the concept of "profit," which Knight regards as compensation for entrepreneurial action.¹⁵ Under Knight's approach, profit is distinct from market returns on investments of property, labor, and capital.¹⁶ Stated more affirmatively, profit is the amount left over (the residual income) for the entrepreneur after all of the providers of property, labor, and capital have been paid.¹⁷ This narrow understanding of profit

(citing Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 332).

10. See Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 332 ("[I]nsider trading is an inefficient compensation scheme. It amounts to paying managers in lottery tickets. The ticket costs the shareholders the actuarial value of the payoff, but risk-average managers value the ticket at less than that. The managers receive less than the firm gives up. Both shareholders and managers could gain by abolition of insider trading." (citing Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 808 (1980)); Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 808 (1980).

11. See Boyle, *supra* note 5, at 1506 ("Manne has based his argument on originality and uniqueness, but something can be uniquely bad as well as uniquely good."); Fox, *supra* note 9, at 288 (arguing that "since insiders can profit from trading on negative as well as positive information, the availability of insider trading creates as much incentive to run the company into the ground as to take it to the sky"); Seligman, *supra* note 7, at 1095 ("Corporate insiders would be able to profit just as much from adverse corporate events as from good news.").

12. Robert A. Prentice & Dain C. Donelson, *Insider Trading as a Signaling Device*, 47 AM. BUS. L.J. 1, 5 (2010) (stating that "compensation will be determined by [the inside trader's] existing wealth and ability to line up the financing necessary to trade" (citing Mendelson, *supra* note 7, at 490)); Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne*, *Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1455 n.84 (1967) ("Why should the innovating entrepreneur, who happens to have inherited wealth, profit much more from his 'entrepreneurial' acts than his equally creative colleague who inherited nothing?").

13. MANNE, *supra* note 1, at 135–36.

14. FRANK H. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* (1921); MANNE, *supra* note 1, at 112.

15. KNIGHT, *supra* note 14, at ix–xi.

16. *Id.* at 18 n.2 (referring to this concept as "pure profit").

17. *Id.* at 18–19. See also Frank H. Knight, *Profit and Entrepreneurial Functions*, 2 J. ECON. HIST., no. 51, Dec. 1942, at 126, 127 (1942) (stating that "profit" must be defined to exclude wages or interest at the "going rate" for the entrepreneur's own labor or capital).

suggests entrepreneurial services are different from other factors of production¹⁸ and implies a special role for the entrepreneur. Knight argues that the entrepreneurial role fundamentally depends on the distinction between “risk” and “uncertainty.”¹⁹

In common parlance, risk arises from any uncertainty about the future, but Knight distinguishes situations in which the distribution of potential outcomes is quantifiable (“risk”) from situations in which the distribution of potential outcomes is unquantifiable “because the situation dealt with is in a high degree unique” (“uncertainty”).²⁰ Stated more directly, “risk” is predictable and “uncertainty” is not.²¹ Where outcomes can be predicted, competition eliminates profit.²² Of course, market participants must still be compensated for bearing risk, so the providers of property, labor, and capital will earn a market rate for the assumption of risk, even in a perfectly competitive market. But profits are generated only under conditions of uncertainty.²³

If the role of the entrepreneur is to navigate in situations of uncertainty, and uncertainty presumes lack of predictability, is the entrepreneur’s compensation (profit) merely the result of luck? Stated another way, are the returns from venturing into uncertainty purely random? More to the point of this Essay, would an entrepreneur actually benefit from trading on inside information if the outcomes on which he is speculating are unpredictable?

Manne understood that “profit” in a Knightian sense arises from an increase in value from an unpredictable event.²⁴ Manne also understood that the source of uncertainty was the lack of reliable information.²⁵ But

18. FRANK H. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* at lix (Beard Books 2002) (1921) (arguing that “entrepreneurship [is not] to be treated as a ‘factor of production’ on a par with others, since it is not in at all the same sense measurable or subject to varying proportions and marginal imputation”).

19. KNIGHT, *supra* note 14, at 19 (observing that the “confusion of ideas [regarding profit] goes deep down into the foundations of our thinking” and, as indicated by the title of the book, the “key to the whole tangle will be found to lie in the notion of risk or uncertainty and the ambiguities concealed therein”).

20. *Id.* at 233.

21. *Cf.* MANNE, *supra* note 1, at 113 (“*Risk* in this context refers to changes in value that may in some sense be said to be predictable The concept of uncertainty relates to the areas of men’s ignorance, even in an approximate probability sense, of what the future holds.”).

22. KNIGHT, *supra* note 14, at 18.

23. *See id.* at 310–11 (“Profit arises out of the inherent, absolute unpredictability of things, out of the sheer brute fact that the results of human activity cannot be anticipated and then only in so far as even a probability calculation in regard to them is impossible and meaningless.”).

24. MANNE, *supra* note 1, at 114.

25. *Id.*

Manne suggested that a “functional definition of uncertainty” would allow for the existence of “a bit of information about the course of events[,]” as long as that information was available “only at a cost most men are unwilling to pay[.]”²⁶

This analytical move is at the core of Manne’s argument, as it allows him to describe a world in which some people (insiders) are merely assuming risk while other people (outsiders) are acting under uncertainty.²⁷ Thus, rather than describing the corporate entrepreneur as a person who ventures into uncertainty, Manne suggests that “the entrepreneur does not perform tasks that are *in their detail* predictable.”²⁸ Manne seems caught by the ability of the entrepreneur to predict the outcome of his action while outsiders are taken wholly by surprise.

Knight had offered an alternative solution to the problem of random returns in the world of uncertainty. While Manne caricatured Knightian uncertainty as “an absolute lack of knowledge about the future[.]”²⁹ Knight was not describing a circumstance in which outcomes were random. Although the entrepreneur exists because market participants lack perfect foreknowledge,³⁰ Knight claimed that the role of the entrepreneur is to “improve knowledge, especially foresight, and bear the incidence of its limitations.”³¹ Knight calls this attribute of entrepreneurs a form of “judgment.”³²

Some judgments are susceptible to measurement, such as the results of a coin flip, which Knight calls “*a priori*” probability,³³ while other judgments produce results that are similar to past events for which we have made repeated empirical observations, which Knight calls “[s]tatistical probability.”³⁴ When a judgment about the future is based on measurement in one of these ways, the predicted event is said to be subject to risk.³⁵

26. *Id.*

27. *Id.* at 115.

28. *Id.* (emphasis added).

29. *Id.* at 114.

30. KNIGHT, *supra* note 18, at lix (“Universal foreknowledge would leave no place for an ‘entrepreneur.’”).

31. *Id.*

32. KNIGHT, *supra* note 14, at 311.

33. *Id.* at 224 (describing situations involving *a priori* probability as those in which “‘chances’ can be computed on general principles”).

34. *Id.* at 225.

35. See NICOLAI J. FOSS & PETER G. KLEIN, ORGANIZING ENTREPRENEURIAL JUDGMENT: A NEW APPROACH TO THE FIRM 84 (2012).

The more interesting judgments, for our purposes, are those that Knight labels as “estimates.”³⁶ These judgments cannot be measured because the circumstances in which they are made are unique.³⁷ This is the usual domain of entrepreneurship, which “involves the discovery, evaluation and exploitation of opportunities to introduce new goods and services, ways of organizing, markets, processes, and raw materials through organizing efforts that previously had not existed.”³⁸ When a judgment about the future is not based on measurement, the predicted event is subject to uncertainty.³⁹

Armed with this more nuanced understanding of risk and uncertainty, the shortcoming of Manne’s proposal is quite clear: the entrepreneur in Manne’s proposal has thought of and operationalized an innovation, but has not yet disclosed the innovation to the world.⁴⁰ Manne would have this entrepreneur trade on the information about her own accomplishment, as if the entrepreneur had left the realm of uncertainty and entered the domain of risk (while the rest of the world continued to labor under uncertainty).⁴¹ The problem here is that the entrepreneur must purchase shares before the market validates the idea. Prior to disclosure, the innovation remains merely the entrepreneur’s estimate about the future, and there is no reason to think that the entrepreneur would gain from trading in a world of uncertainty.

This insight suggests a still deeper concern with Manne’s proposal, namely, that the would-be corporate entrepreneur who is allowed to gain through insider trading would have an incentive to avoid venturing into the land of uncertainty, where judgments about the future are unmeasurable. Instead, the entrepreneur would be incentivized to engage in measurable risk taking. Manne criticized profit-sharing plans, like bonuses and stock options, on the ground that they “induce the smaller kinds of innovations and cost-saving techniques rather than radical, major, dramatic developments.”⁴² The legalization of insider

36. KNIGHT, *supra* note 14, at 225.

37. *Id.* (stating that “there is *no valid basis of any kind* for classifying instances”).

38. SCOTT SHANE, A GENERAL THEORY OF ENTREPRENEURSHIP: THE INDIVIDUAL-OPPORTUNITY NEXUS 4 (2003) (citing S. Venkataraman, *The Distinctive Domain of Entrepreneurship Research: An Editor’s Perspective*, in 3 ADVANCES IN ENTREPRENEURSHIP, FIRM EMERGENCE, AND GROWTH 119, 130–31 (Jerome A. Katz ed., 1997); Scott Shane & S. Venkataraman, *The Promise of Entrepreneurship as a Field of Research*, 25 ACAD. MGMT. REV. 217, 220 (2000)).

39. *See supra* notes 25–27 and accompanying text.

40. MANNE, *supra* note 1, at 133.

41. *See supra* notes 25–27 and accompanying text.

42. MANNE, *supra* note 1, at 136.

trading would provide a strong incentive to produce such incremental advancements.

Manne's conception of the corporate entrepreneur who is compensated through insider trading rests on an implausible account of the viability of trading on entrepreneurial action, but what of the incentive problem he identifies? Is Manne correct to assert that "[a]n individual cannot be hired to perform x amount of entrepreneurial service"?⁴³ Some of Knight's passages seem to support this notion,⁴⁴ but Ronald Coase famously countered Knight by claiming that people could simply sell their superior judgment.⁴⁵ After all, "[e]very business buys the services of a host of advisers."⁴⁶

Others agree with Knight that markets for entrepreneurial judgment are closed and suggest that one implication of this fact is that "the entrepreneur has to start a firm to capture the returns to his judgment."⁴⁷ To be sure, the facilitation of startups through innovative financing ecosystems seems to have largely resolved the incentive problem Manne identified.⁴⁸ Contrary to Manne's observations in 1966,⁴⁹ the Silicon Valley model of startup financing does not require entrepreneurs to be wealthy to found their own businesses,⁵⁰ and the staged financing of startups by outside investors provides ample incentive for entrepreneurs to plunge into uncertainty.⁵¹

43. *Id.* at 133.

44. KNIGHT, *supra* note 14, at 251 (describing decisions made in the face of uncertainty as depending on factors that "are so largely on the inside of the person making the decisions" that they are not subject to measurement).

45. R. H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 400–01 (1937). *But see* Nicolai J. Foss, *The "Alternative" Theories of Knight and Coase, and the Modern Theory of the Firm*, 18 *J. HIST. ECON. THOUGHT* 76, 88 (1996) (arguing that entrepreneurial judgment cannot be traded on a market).

46. Coase, *supra* note 45, at 400.

47. *See, e.g.,* FOSS & KLEIN, *supra* note 35, at 166. *But see* RICHARD N. LANGLOIS, *THE DYNAMICS OF INDUSTRIAL CAPITALISM: SCHUMPETER, CHANDLER, AND THE NEW ECONOMY* 86 (2007) ("[C]hanges in technology and markets opened up attractive rent-seeking possibilities that could be seized only by breaking down or 'unbundling' the vertical structure of the managerial corporation.").

48. MANNE, *supra* note 1, at 133.

49. *Id.* at 119–20.

50. *See, e.g.,* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 *STAN. L. REV.* 1067, 1070–76 (2003) (detailing how the venture capital market provides financing for startups).

51. *See* D. Gordon Smith, *Team Production in Venture Capital Investing*, 24 *J. CORP. L.* 949, 965–70 (1999) (describing the benefits of staged financing to the venture capitalist and the entrepreneur).

Research on entrepreneurship within established organizations—now often referred to as “corporate entrepreneurship”⁵² or “intrapreneur[ship]”⁵³—also suggests that the proliferation of profit-sharing compensation (primarily stock option plans) over the past several decades encourages entrepreneurial action, contrary to Manne’s speculation. The study of corporate entrepreneurship tends to focus on ways to dislodge organizational inertia.⁵⁴ Established firms may engage in intrapreneurship by launching new business ventures related to their existing products or markets; creating new products, services, or technologies; reformulating their existing strategies or reorganizing the firm; and “pursuing enhanced competitiveness [through] initiative and risk taking . . . competitive aggressiveness and boldness.”⁵⁵ Corporate entrepreneurship is increasingly viewed as a strategic imperative.⁵⁶

Manne focuses on the individual corporate entrepreneur, but researchers sometimes consider companies to be intrapreneurial as a whole, with each individual within the firm being capable of entrepreneurial behavior.⁵⁷ From this perspective, corporate entrepreneurship is conducted by groups or teams. In some cases, these teams are tasked with a specific assignment, but other times, the teams are created in a less formal, ad hoc manner. In either case, the teams might evolve and change during the life of the entrepreneurial endeavor.

Although Manne’s proposal assumes that financial incentives are a principal driver of corporate entrepreneurship, the organizational structure and values of a company can have a significant impact on levels of corporate entrepreneurship:

52. See, e.g., MICHAEL H. MORRIS, DONALD F. KURATKO & JEFFREY G. COVIN, *CORPORATE ENTREPRENEURSHIP & INNOVATION* 11–12 (3d ed. 2011).

53. See, e.g., GIFFORD PINCHOT III, *INTRAPRENEURING: WHY YOU DON’T HAVE TO LEAVE THE CORPORATION TO BECOME AN ENTREPRENEUR*, at xi–xiii (1985).

54. D. Gordon Smith & Masako Ueda, *Law & Entrepreneurship: Do Courts Matter?*, 1 *ENTREPRENEURIAL BUS. L.J.* 353, 356 (2006).

55. Bostjan Antoncic & Robert D. Hisrich, *Intrapreneurship: Construct Refinement and Cross-Cultural Validation*, 16 *J. BUS. VENTURING* 495, 499 (2001).

56. See, e.g., Shelley Morrisette & William Oberman, *Shifting Strategic Imperatives: A Stages of Leadership Perspective on the Adoption of Corporate Entrepreneurship*, 18 *J. APPLIED MGMT. & ENTREPRENEURSHIP*, no. 2, 2013, at 59, 64 (“Companies cannot remain static, but must continuously adjust, adapt or redefine themselves.” (citing MICHAEL H. MORRIS, DONALD F. KURATKO & JEFFREY G. COVIN, *CORPORATE ENTREPRENEURSHIP & INNOVATION* 4–7 (2d ed. 2008))).

57. MANNE, *supra* note 1, 115–16; Olga Belousova & Benoît Gailly, *Corporate Entrepreneurship in a Dispersed Setting: Actors, Behaviors, and Process*, 9 *INT’L ENTREPRENEURSHIP & MGMT. J.* 361, 362 (2013) (describing “dispersed corporate” entrepreneurship, which “assumes that entrepreneurial initiatives are developed as embedded in the corporate context by the employees who combine the entrepreneurial activity with their ‘job as usual[.]’”).

Firms that nurture organizational structures and values conducive to intrapreneurial activities and have intrapreneurial orientations are more likely to grow than organizations that are low in such characteristics. Open and quality communication, existence of formal controls, intensive environmental scanning, management support, organizational support, and values help an organization become more intrapreneurial.⁵⁸

In some companies, entrepreneurship is conducted within separate organizations created at a distance from the main company.⁵⁹ This practice is sometimes motivated by a belief that “entrepreneurship and management are fundamentally different processes and that they need to be separated structurally.”⁶⁰ Managers of large corporations have become increasingly interested in startup success and have attempted to incorporate practices and structures conducive to startup success within established firms, including corporate venture capital⁶¹ and corporate incubation.⁶² It is not clear that Manne’s proposal would encourage either of these practices.

The main thrust of Manne’s proposal relates to compensation for entrepreneurial services. According to Manne, a compensation mechanism that would encourage entrepreneurial action “should not require a large, long-term financial investment by the entrepreneur”⁶³ and cannot be determined in advance because “[t]rue innovation cannot be predicted nor its value known before it has been thought of and made

58. Antoncic & Hisrich, *supra* note 55, at 523.

59. L.D. DeSimone, George N. Hatsopoulos, William F. O’Brien, Bill Harris, Charles P. Holt, *How Can Big Companies Keep the Entrepreneurial Spirit Alive?*, HARVARD BUS. REV. (Nov.-Dec. 1995), <https://hbr.org/1995/11/how-can-big-companies-keep-the-entrepreneurial-spirit-alive> [<https://perma.cc/5PZ2-P8ZD>].

60. Belousova & Gailly, *supra* note 57, at 363.

61. Tobias Weiblen & Henry W. Chesbrough, *Engaging with Startups to Enhance Corporate Innovation*, 57 CAL. MGMT. REV., no. 2, Winter 2015, at 66, 70 (“An obvious means for a company to engage in entrepreneurial activity is to finance it. Equity stakes in promising external startups allow a corporation to keep an eye on interesting technologies and markets, influence the decisions of their portfolio companies, and potentially profit financially.”).

62. *Id.* at 71 (“Not all smart ideas and promising technologies are found out in the wild—in some cases, they are born in the corporate environment, but do not fit with the current core business or business model. To profit from such cases of ‘misfit’ internal innovation, corporate incubators have emerged as a means to bring them to market as new companies.”).

63. MANNE, *supra* note 1, at 133 (noting that without some guarantee that anyone may sell entrepreneurial services, “we should anticipate that entrepreneurial profits would be gained only by those wealthy enough to found their own businesses and exploit their own innovations”). Clearly, Manne was writing before the advent of Silicon Valley-style venture capital investing.

effective.”⁶⁴ Based on these two attributes of the compensation system, Manne eliminates salary,⁶⁵ bonuses,⁶⁶ and stock options⁶⁷ as meaningful incentive mechanisms. Manne offers only a tepid endorsement of profit-sharing plans,⁶⁸ but more recent research on corporate entrepreneurship shows that “employees’ willingness to participate in a new corporate venture increases with increased profit sharing[.]”⁶⁹

Like many entrepreneurship scholars, Manne distinguishes “managers” and “entrepreneurs,”⁷⁰ but in most firms, the CEO is ultimately responsible for creating an emphasis on corporate entrepreneurship.⁷¹ Consistent with Manne’s thesis, a CEO’s willingness to engage in or encourage entrepreneurial behavior is determined by compensation structure.⁷² Short-term compensation, which “typically includes salary, annual bonuses, and other short-term incentives[.]” discourages pursuit of a risky strategy.⁷³ Conversely, “[l]ong-term compensation, which links the rewards of executives to long-term organizational performance, usually includes stock options, restricted stock grants, and other long-term incentives[.]” and so encourages riskier behavior in return for a better payout.⁷⁴ Thus, Manne’s reservations about profit-sharing plans do not seem justified.

Manne purports to ground his analysis of insider trading on Frank Knight’s distinction between risk and uncertainty, but as stated above, Manne amends Knight’s understanding of uncertainty by assuming that the entrepreneur has information about the future that is not possessed by the market as a whole. Modern entrepreneurs behave more like the

64. *Id.* at 133 (noting that an implication of this indeterminacy is that “[a]n individual cannot be hired to perform *x* amount of entrepreneurial service”).

65. *Id.* at 134 (“Salary is appropriate only to purchase a known service in the labor market.”).

66. *Id.* (arguing that a profit-sharing plan “in which the recipients and their percentage of profits are determined in advance” makes the employee an investor and risk-taker, but not an entrepreneur).

67. *Id.* at 136–37 (lamenting that stock options must be granted prior to the innovation).

68. *Id.* at 135–36 (conceding that a profit-sharing bonus “tends to give some incentive for entrepreneurial activity[.]” but suggesting that any profit-sharing plans’ “tendency will be to induce the smaller kinds of innovations and cost-saving techniques rather than radical, major, dramatic developments”).

69. Erik Monsen, Holger Patzelt & Todd Saxton, *Beyond Simple Utility: Incentive Design and Trade-Offs for Corporate Employee-Entrepreneurs*, 34 ENTREPRENEURSHIP THEORY & PRAC. 105, 118 (2010).

70. MANNE, *supra* note 1, at 115–17.

71. Yu-Kai (Mike) Wang, Chris Changwha Chung & Dominic S.K. Lim, *The Drivers of International Corporate Entrepreneurship: CEO Incentive and CEO Monitoring Mechanisms*, 50 J. WORLD BUS. 742, 744 (2015).

72. *Id.*

73. *Id.* at 745.

74. *Id.*

entrepreneurs imagined by Knight, investing in their own judgment by accepting stock compensation when they make a decision to found or join a firm,⁷⁵ thus effectively solving the incentive problem Henry Manne identified without needing to legalize insider trading.

75. See KNIGHT, *supra* note 14, at 311; Richard Harroch, *How Employee Stock Options Work in Startup Companies*, FORBES (Feb. 27, 2016, 10:32 AM), <https://www.forbes.com/sites/allbusiness/2016/02/27/how-employee-stock-options-work-in-startup-companies/#3ec73c526633> [<https://perma.cc/LH2G-7NMY>].